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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1936

No. 389

THE KNOX NATIONAL FARM LOAN ASSOCIATION, A CORPORATION, AND THE FEDERAL LAND BANK OF LOUISVILLE, A CORPORATION,

Petitioners,

vs.

ARTHUR C. PHILLIPS,

Respondent.

BRIEF ON BEHALF OF PETITIONERS.

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as the Federal Farm Loan Act (12 U. S. C., Ch. 7, §§ 641, *et seq.*).[1]

The decision of the Court of Appeals of Knox County, Ohio, is a final judgment reviewable by this Court. Said Court of Appeals is the highest court of said State having jurisdiction over this case, except upon the discretionary assumption of jurisdiction by the Supreme Court of Ohio, the court of last resort of said State.[2] Said decision and judgment became final June 24, 1936, when the Supreme Court of Ohio overruled petitioners' motion for an order directing said Court of Appeals to certify its record to said Supreme Court. (R. p. 115.)[3]

III. Statement of Facts.

The Knox National Farm Loan Association (referred to in this brief as the Association) is a cooperative membership corporation, chartered by the Federal Farm Loan Board, as part of a nation-wide farm loan system. (12 U. S. C. §§ 711-722.) The Association was organized for the purpose of enabling its members to obtain loans from the Federal Land Bank of Louisville, on the security of qualified farm mortgages indorsed by the Association. The capital stock of the Association is owned entirely by members, and membership is confined to borrowers from the Bank. (R. p. 7; 12 U. S. C. § 733.)

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[1] For the convenience of the Court, petitioners have filed with the Clerk copies of a compilation of the Federal Farm Loan Act and other laws relative to Federal agencies for farm mortgage credit. This compilation, published by the Farm Credit Administration, sets forth the several statutes, as amended, in accordance with the codification thereof in Title 12 of the United States Code.

[2] Constitution of Ohio, Article IV, §6. "* * * judgments of the courts of appeal shall be final in all cases except * * * cases of public or great general interest in which the Supreme Court may direct any court of appeals to certify its record to that court."

[3] *American Railway Express Co.* v. *Levee*, 263 U. S. 19, 20.

The Federal Land Bank of Louisville (referred to in this brief as the Bank) is one of twelve Federal land banks chartered by the Federal Farm Loan Board under the provisions of said Act. (12 U. S. C. §§ 671-683.) The Bank has its principal place of business in the City of Louisville, State of Kentucky, and is authorized by its charter to do business in the States of Ohio, Indiana, Kentucky and Tennessee. (R. p. 7.)

This case grows out of transactions relating to a loan which was made through the Association some years ago. The various incidents to making and carrying such loans are prescribed, in great detail, by the Federal Farm Loan Act. For that reason, the transactions leading up to the present suit are tabulated in the appendix to this brief, opposite quotations from the applicable provisions of the Act. (Appendix, p. 91, *et seq. infra.*) A brief outline of the essential facts is set forth in the following paragraphs.

In 1927, Respondent purchased a farm in Knox County, Ohio, and assumed a mortgage which had been given by his vendor to the Bank to secure a loan obtained through the Association. At the same time, Respondent assumed the stock interests of his vendor (53 shares of paid-up stock in the Association, with a par value of $5 each), and became a member of the Association, as permitted by 12 U. S. C. § 771, Sixth (R. p. 47). Respondent's stock was held by the Association as collateral security for the payment of said loan, pursuant to the requirement of 12 U. S. C. §§ 721, 733. The Association's receipt for such stock stated, in part, that Respondent's stock in the Association "will be accepted at face value upon final payment of the loan." No provision of this character was contained in the Act or in the note and mortgage held by the Bank. (R. pp. 29, *et seq.*)

The mortgage loan was payable in installments over a period of 34½ years, but Respondent had the option of pay-

ing off the unmatured balance or any part thereof on July 1, 1930, or on any installment date thereafter, subject to the regulations of the Farm Credit Administration. (12 U. S. C. § 771, Second.)

On March 25, 1933, Respondent made the following tender to the Bank, as in full payment of his debt: cash in the amount of $1,857.50; together with Respondent's stock in the Association, the par value of which ($265), added to said cash, was equal to the unpaid balance of the mortgage debt as of the next installment date. This tender was refused. (R. pp. 3, 4.)

Thereafter, Respondent paid the sum of $1,857.50 on account of his mortgage debt, leaving an unpaid balance of $265. He made repeated demands on the Bank and the Association that his stock be accepted in settlement of said balance.

At the time of said tender and payment, and at all times since, the Association was indebted to the Bank for amounts which it could not meet from current assets, and had no funds available for distribution to stockholders. (R. p. 55.)

IV. Proceedings in the Courts Below.

Respondent brought this suit against the Bank and the Association in the Court of Common Pleas of Knox County, Ohio. Respondent's petition stated, in substance, the facts outlined in the preceding section of this brief. The petition alleged, in substance, that Respondent had made a legal tender of the full amount of the mortgage debt, by offering the Bank his receipt for stock in the National Farm Loan Association (par value $265) together with cash for the remainder of the unpaid balance.

Although Respondent's petition is somewhat obscure, it may fairly be construed in the light of his position throughout the case, as alleging: (1) that the Association had exe-

cuted a valid agreement to accept his stock at face value on final payment of the loan, such agreement being contained in the Receipt for Stock; (2) that the Federal Farm Loan Act requires that the stock be so accepted; and (3) that the Act requires the Bank to credit Respondent's loan with the par value of his stock in the Association, when the loan has been paid down to that amount.

Respondent further alleged in his petition that the Association's capital was impaired, and that it was continuing operations at the risk of further losses and further impairment of its capital stock, to the detriment of his interests as a shareholder (R. p. 4).

Respondent prayed for the following relief (R. p. 5):

1. That the Bank be required to pay off at par and retire the shares of stock issued to him by the Association.

2. That the Bank be required to surrender the promissory note and mortgage, duly canceled, and that Respondent's title to the real estate be quieted as against said mortgage.

3. That a receiver be appointed to take charge of the business and property of the Association, and to wind up and liquidate its affairs.

Separate answers were filed by the Association and by the Bank. The Bank also filed a cross petition, alleging that the mortgage debt had been reduced to approximately $265 by a cash payment made in April of 1933, that Respondent had subsequently failed and refused to make further payments on account of said mortgage debt as they matured, and that he was in default. The Bank prayed judgment for the full unpaid balance and for a foreclosure of its mortgage for the satisfaction of such judgment (R. p. 29, *et seq.*).

The case came on for trial in April of 1935. At the hearing, the facts previously outlined were established. The financial condition of the Association, as of the date of the

trial, was shown by a statement which Respondent's attorney introduced in evidence. (R. pp. 55, 72, 73.)

This financial statement shows that the Association has 179 members; for whom it has endorsed loans in the total original amount of $493,200. The Association's capital (invested in capital stock of the Federal land bank) is $24,660. The Association's only creditor is the Federal Land Bank. The Association's account with the Bank shows a debit balance of $997.60—the difference between the Association's liability for losses sustained upon the foreclosure of two indorsed mortgages, and the current assets which are available for the payment thereof. This deficiency of current assets is 4.04 per cent of the Association's capital. The Association has a further potential impairment of capital (estimated at $3,563.61) which may or may not develop upon the liquidation of real estate securing certain indorsed loans which have gone to foreclosure.

It was further established at the hearing that, during the two-year period since Respondent had made his original tender, the Association had indorsed and become liable for the payment of new loans aggregating more than $100,000; and that during the entire period, its capital had been impaired. (R. p. 57.)

Upon conclusion of the testimony, the case was taken under advisement by the trial judge, and no further proceedings were had for several months.

On October 7, 1935, the trial court entered the first of two judgments, disposing of one phase of the case. The court found that Respondent was still indebted to the bank for the balance of his mortgage debt over and above the cash payment made in 1933, and ordered that the Bank cancel and deliver up the note and mortgage, within fifteen days after receipt of said sum ($265). The order further provided that, if the Bank should fail to comply, it should stand as a

decree quieting Respondent's title as against the lien of the mortgage. (R. p. 93.) Immediately thereafter, Respondent paid the sum of $265, and the Bank surrendered its note and mortgage, duly canceled.

On November 18, 1935, a second order was entered by the trial court. (R. p. 97.) The court found that Respondent had fully paid his entire debt to the Bank, and therefore was entitled to the retirment and repayment of his shares of stock in the Association. The court entered judgment against the Association for $265, the par value of said stock, with interest thereon from the date of the judgment at 6 per cent per annum. (R. p. 98.)

The court further found that the Association had been insolvent for more than two and one-half years prior to the date of the decree; that during such period the Association had made itself contingently liable for new loans aggregating more than $100,000; and that Respondent had been obliged to continue as a stockholder against his will and desire, long after he had "tendered to the defendants [Bank and Association] * * * the full amount due upon the debt * * *, and made demand and request upon the defendants for the retirement and repayment to him at par value of his said 53 shares of the capital stock of said defendant * * * association."

Upon the facts so found, the court decreed that Respondent was entitled to the liquidation of the affairs of the Association. A receiver was appointed and ordered to take possession of any and all property of the Association, and to use, manage and conduct the business of the Association in accordance with his best judgment and discretion, and to deposit any funds that may come into his hands in The Knox National Bank in Mt. Vernon. The court ordered the officers of the Association and all other persons to deliver up to the receiver any property belonging to the Association of any

kind or description, and restrained all persons from interfering in any manner with the receiver.

The Association and the Bank appealed to the Court of Appeals of Knox County, Ohio, from the judgment entered November 18, 1935. By a judgment entered April 16, 1936, the Court of Appeals affirmed the judgment of the trial court, and remanded the cause for further proceedings. In connection with its judgment, the Court of Appeals handed down an opinion which contained substantially the following rulings of law:

> The Federal Farm Loan Act requires a national farm loan association, whether solvent or insolvent, to pay off at par the capital stock owned by a member, immediately upon the repayment of his loan. (R. p. 109).
>
> Under the plain terms of the Act, a member who has fully paid his indorsed loan is entitled to judgment against the association for the par value of his capital stock, regardless of the solvency or insolvency of the association. (R. p. 111.)
>
> The Act requires a Federal land bank to credit its borrower's mortgage debt with the par value of collateral (capital stock in said bank) owned and pledged by the indorsing national farm loan association. The borrower is entitled to such credit when he has paid his loan down to an amount equal to the par value of the collateral pledge. (R. pp. 109, 110.)
>
> When a national farm loan association issues a receipt to its member for the shares of its capital stock which are purchased and pledged with it as collateral security for the payment of an indorsed loan, and states in such receipt that the stock will be accepted at par upon final payment of said loan, such receipt constitutes a valid and unconditional contract to redeem said stock at par, and may be enforced regardless of the association's solvency or insolvency. (R. p. 111.)
>
> Where an association fails to pay off at par the capital stock of a member who has retired his loan, such member is both a creditor and stockholder. He is en-

titled to demand that the association be liquidated and wound up by a state court, if it is continuing to indorse new loans while its capital is impaired. (R. pp. 109, 111.)

The Federal Farm Loan Act does not confer exclusive jurisdiction upon the Farm Credit Administration to liquidate and wind up an insolvent national farm loan association. (R. p. 112.)

The Bank and the Association filed a motion in the Supreme Court of Ohio for an order directing the Court of Appeals of Knox County to certify its record to the Supreme Court. This motion was overruled on June 24, 1936, whereupon the decision of the Court of Appeals became final.

V. Proceedings in This Court.

On September 23, 1936, the Bank and the Association applied to this Court for a writ of certiorari, to review the decision of the court below, upon a specification of errors identical with the assignments set forth below. A writ of certiorari was granted by this Court on November 9, 1936.

VI. Assignments of Error.

The court erred—

1. In affirming judgment against the Association for the par value of Respondent's stock.

2. In holding that the Federal Farm Loan Act requires the Federal Land Bank to credit the maker of a mortgage note with the proceeds of collateral security (bank stock) owned and pledged by the indorser of the note (the national farm loan association of which the maker is a member and shareholder).

3. In affirming the appointment of a receiver to wind up and liquidate the Association's business.

4. In holding that the Ohio statutes, relative to the appointment of a receiver in an action to quiet title to real estate were applicable to this case; and in failing to recognize that all controversy relative to title had been eliminated upon respondent's payment of the entire mortgage debt, during the interim between the filing of suit and the appointment of a receiver to liquidate the Association, and that the sole remaining questions involved the interpretation of the Federal Farm Loan Act.

VII. Summary of Argument.

1. A national farm loan association is a cooperative membership corporation, organized for the purpose of obtaining loans for its members, upon its indorsement, from the Federal Land Bank of its district. It is an integral part of the Federal Farm Loan System. Its members may not evade their responsibility by withdrawing when the association is insolvent.

2. The Farm Loan Act contemplates a solvent association in providing for retirement of the stock of withdrawing members.

3. The Association did not agree to confer upon Respondent the status of creditor for the amount of his capital subscription, and any contract purporting to confer such status would have been ultra vires and unenforceable.

4. The Farm Loan Act does not require a Federal Land Bank to credit the maker of a mortgage note with the proceeds of collateral security owned and pledged by the indorser of the note.

5. A national farm loan association is an instrumentality of the United States, and jurisdiction to wind up such association upon insolvency is vested exclusively in the Farm Credit Administration.

6. The Farm Credit Administration has discretionary authority to appoint or not to appoint a receiver for an insolvent national farm loan association; and to permit an association to continue business operations, notwithstanding an impairment of capital stock which appears to be temporary, provided the rights of stockholders and creditors are adequately protected.

VIII. ARGUMENT.

1. A national farm loan association is a cooperative membership corporation, organized for the purpose of obtaining loans for its members, upon its indorsement, from the Federal land bank of its district. It is an integral part of the Federal Farm Loan System. This relationship is meaningless if Respondent can evade his responsibility by withdrawing when the Association is insolvent.

In previous cases this Court has examined the provisions of the Federal Farm Loan Act respecting national farm loan associations, and has described the functions of these associations as integral parts of the Federal land bank system. In *Smith* v. *Kansas City Title and Trust Co.*, 255 U. S. 180, 203, the Court reviewed, in considerable detail, the statutory procedure for making loans through national farm loan associations,[4] and stated:

> "Loans [by Federal land banks] on farm mortgages are to be made to *cooperative borrowers* through the organization of corporations known as National Farm Loan Associations, * * *." (Italics added.)
>
> "No persons but borrowers on farm loan mortgages shall be members or shareholders of National Farm Loan Associations."
>
> "Shareholders in Farm Loan Associations are made individually responsible for the debts of the Associa-

[4] The procedure described in the Smith case was followed in the present case. Each step in that procedure is shown in the appendix to this brief, pages 91, et seq.

> tion to the extent of the amount of stock owned by them respectively, in addition to the amount paid in and represented by their shares."

In *Federal Land Bank* v. *Gaines*, 290 U. S. 247, this Court again reviewed the provisions of the Act for loans through national farm loan associations. And again, the Court referred to the cooperative features of the Act, stating:

> "The borrower is under no legal compulsion to borrow. If he takes the benefit of the privilege extended by the statute he can do so only in compliance with its requirement that he shall join, with himself as obligor, the local cooperative association of which he is a member."

The legislative history of the Act, as this Court recognized in the *Gaines* case (*supra*), expressly confirms the apparent intention of Congress to establish a cooperative banking system. In submitting the first draft of the measure which became the Federal Farm Loan Act, a joint Committee of the Senate and House of Representatives stated (*H. R., Doc. No. 491, 64th Congress, 1st Session*):

> "In order to secure intimate touch with the borrowers, it is provided that the land bank shall make loans to farmers through local associations of borrowers, called national farm loan associations. These associations do not conduct a banking business. Their operations are very simple. They admit members who desire to borrow; their directors and loan committees pass on the value of the security and the character of the borrower. Every borrower takes stock in the farm loan association to the amount of 5 per cent of the face of his loan. This amount is subscribed by the association to the stock of the land bank, thus providing for a capital proportionate to the amount of loans, approximating 1 to 20." (P. 8.)

"* * * the special capabilities of the land-bank managers must be supplemented by an intimate knowledge of the borrower and his affairs, particularly of the farm land he offers as security. This supplementary knowledge is furnished without additional cost through the local associations." (P. 12.)

"*At the outset we secure the personal interest of the borrower by requiring him to contribute to the capital of the loan association 5 per cent of the face of his loan. This personal stake makes the system mutual and makes the borrower a cooperator.* * * * *He knows that if the association recommends and indorses a bad loan, he may be called on to help make the loan good.* (Italics added.) (P. 13.)

"We should thus expect every member to keep careful watch lest his loan association make unsafe loans, with resulting personal loss to him. We should also expect him to see that the best available men in the community act as directors and as members of the loan committee." (P. 13.)

"Our country lags far behind Europe in most matters of cooperation among farmers. There are conditions which render it more difficult here than in older countries. But so far as cooperation is applicable, and as speedily as we can adapt it to our own conditions, it should be established. (P. 17.)

"The framers of this bill realize that it is but one factor in the vast field for national cooperation that lies before the American farmer. But they entertain the hope that organization for the purpose of securing land mortgage credit will bring neighboring farmers into closer touch all over the Union and will stimulate the cooperative spirit. Those men who organize farm loan associations will become better acquainted and more trustful of each other, so that it will be comparaitvely easy to form organizations among the land mortgage groups for * * * various forms of cooperative activity." (P. 17.)

The Senate Committee on Banking and Currency, in recommending the passage of the measure, adopted as its own the foregoing statements of the Joint Committee respecting the cooperative features of the Federal land bank system. (*Sen. Rep. No. 144, 64th Congress, 1st Session.*).

Similarly, the report of the House Committee on Banking and Currency (*H. R., Rep. No. 630, 64th Congress, 1st Session*) states:

> "* * * the national farm-loan associations and the Federal farm-land banks constitute a system of rural credit essentially cooperative. Every borrower through a farm-loan association must be a stockholder in that association to the extent of 5 per cent of his loan. * * *
>
> "Except for the stock held by borrowers through agents, the entire stock of the land banks will ultimately be held by the various national farm-loan associations.
>
> "The management and administration of the associations is entirely in the hands of the borrowers." (P. 8.)
>
> "All dividends from the earnings of the system are paid to the borrowers themselves as stockholders.
>
> "Opportunity therefore is afforded the farmers of the country to organize a cooperative system whereby an abundant volume of credit is available through the sale of farm-loan bonds. **The attractiveness of these bonds should assure their sale at a low interest rate.** This low interest rate plus the necessary moderate charges for expense of administration and reserves represent exactly the rate at which the farmer can borrow through this cooperative system." (P. 8.)
>
> "In the case of the Federal land banks the profits earned by the banks after expenses and charges have been deducted go to the associations in the form of dividends, and subsequently are paid to the borrowers themselves as stockholders in the associations." (P. 10.)

The Federal Farm Loan Act has now been in force for twenty years, and although it has been repeatedly amended, its cooperative features have been preserved and strengthened. The cooperative Federal land banks are the only permanent banking institutions now authorized to make long-term farm mortgage loans under Government supervision—the privately owned joint stock land banks being prohibited from making new loans (12 U. S. C. § 810).

By the Act of March 4, 1933 (12 U. S. C. § 723), Congress amended the Federal Farm Loan Act to permit the making of direct loans by Federal land banks, in localities where facilities of national farm loan associations are not available. The only cooperative feature of direct loans is the requirement that borrowers subscribe to stock in the Federal land bank in the amount of 5 per cent of their loans. Such loans must bear interest greater than that charged to borrowers through associations. (12 U. S. C. § 723.) Thus, it is apparent that Congress has favored and encouraged cooperative borrowing through national farm loan associations, as opposed to direct borrowing from a Federal land bank.

The legislative preference for cooperative borrowing was further shown by the fact that direct borrowers have the statutory privilege of covenanting, in their mortgages, to form a national farm loan association. (12 U. S. C. § 723.) It is a matter of public record that in administering this provision of the statute, the Farm Credit Administration has required that all mortgages executed by direct borrowers shall contain a covenant of this character; also that the covenant has been regarded as an option in favor of the borrower, rather than a condition enforceable by the Bank. It is also a matter of public record that many thousand direct borrowers have voluntarily joined associations, when such action became possible, thereby obtaining reduced interest rates.

As this Court said in the *Smith* case (*supra*), the members of an association are "cooperative borrowers." They cooperate in furnishing capital to the bank which they patronize. (12 U. S. C. § 721.) They cooperate in scrutinizing the security which is tendered for new loans, and in passing upon the character and credit standing of applicants. (12 U. S. C. § 752.) They cooperate in indorsing and becoming liable for loans made to fellow-members. (12 U. S. C. § 761, First.) They cooperate in seeing that loan funds are used for the purposes stated by applicants; in collecting and forwarding amounts which are payable on indorsed loans; and in ascertaining the amount of any delinquent taxes on land mortgaged as security for indorsed loans. (12 U. S. C. § 714.) They cooperate in making good defaults under indorsed mortgages, and in becoming personally liable, equally and ratably, for all contracts, debts and engagements of their association, to the extent provided by the Act. (12 U. S. C. § 921.)

Thus, the cooperative borrowers who constitute a national farm loan association have active duties to perform in connection with each loan cooperatively obtained, from the moment application is made for such loan until final payment thereof. *Each cooperator has obligations separate and distinct from his own mortgage debt—obligations which cannot be evaded by withdrawing from membership at a time when the association is insolvent.*

2. The Farm Loan Act contemplates a solvent association in providing for retirement of the stock of withdrawing members.

The courts below have held that the Act (12 U. S. C. § 732) requires an association to pay off its stock at par, whether solvent or insolvent. Petitioners believe that this ruling is plainly erroneous, and that in providing for the retirement of stock, the Act contemplates a solvent associa-

tion. Petitioners' position in this regard has been sustained by the highest courts of two states, in the cases quoted below.

In *Byrne* v. *Federal Land Bank*, 61 N. D. 265, 237 N. W. 797, 802, 803, a borrower whose loan had been paid in full brought suit against the Federal land bank and the national farm loan association, to recover the par value of his shares of stock in the association. At the time the loan was paid off, the association was insolvent. In holding that the borrower had no cause of action against the insolvent association, the Supreme Court of North Dakota stated:

> "It is true the act says upon payment of his loan 'the national farm loan association shall pay off at par and retire the corresponding shares of its stock which were issued when such land bank stock was issued' (12 U. S. C. § 721). The plaintiff however is a stockholder in a corporation. *The corporation cannot pay off at par the stock held by the plaintiff if it be insolvent, or if it has no money.*" (Italics added.)
>
> "*While the statute requires the retiring of the shares at par, it contemplates a solvent institution. The plaintiff, by merely paying his loan, cannot escape the responsibility which he assumes as a stockholder. The relationship which he bears to the other shareholders and to the whole system is such that he cannot evade responsibility.* • • • The payment of the loan does not relieve the borrower from his liability as a stockholder. The only assets which a Farm Loan Association has or can have are the shares which it takes in the Federal Land Bank to counterbalance the shares of stock in the association taken by the borrower, such dividends as the shares of stock in the land bank taken by the association may earn, and such 'reasonable initial charges to be made against applicants for loans and to borrowers in order to meet the necessary expenses of the association' as specified in • • • the

act * * *. The statute contemplates that when the loan is paid the stock shall be canceled, and the necessary corollary of this is that the par value of the stock be returned; but it is evident from the statute that Congress had in mind the possibility that such Farm Loan Association may become insolvent." (Italics added.)

"* * * the principle involved in the act is co-operative in its nature. It is only through the co-operation of his neighbors, with their assistance, upon their recommendation and the pledge of their liabilities he can secure his loan. They pledge their faith and credit to aid him, and he pledges his faith and credit to aid them. Having secured their co-operation and assistance and finding his loan paid, he now wants to avoid his responsibilities to those who made it possible for him to get his loan. His rights are not superior to the rights of any other stockholder in the corporation. We have already shown that a solvent corporation cannot declare and pay dividends out of its capital stock so as to render itself insolvent, * * * and if a solvent corporation cannot do this, how may an insolvent corporation pay one stockholder for his stock? The plaintiff is co-operative when he desires a loan and needs the assistance of his neighbors; but becomes extremely individualistic when the loan is paid."

"The record showing the loan association to be insolvent, with no funds to pay its debts, let alone to retire its stock, one shareholder has no right to increase the indebtedness of the others by securing payment for his stock. If he avoid his responsibilities, the burden of debt resting upon those who assisted him is increased. Plaintiff has no cause of action against the association." (Italics added.)

The same conclusion was reached by the Supreme Court of Arkansas in *Western Clay National Farm Loan Association* v. *Lilly*, 189 Ark. 1004, 76 S. W. (2d) 55. The Arkan-

sas court quoted at length from the *Byrne* case (*supra*), in support of the conclusion that a borrower has no right of action against an insolvent national farm loan association, for the par value of stock issued in connection with a loan which has been retired. In its opinion the court stated:

> "If a borrower be permitted to pay off his loan and withdraw his capital stock at par value in an insolvent association, there is no co-operation left.
>
> "Manifestly co-operation is the ground work of the original act. * * * each borrower in a local association to the extent of his stock * * * is surety for the loans of all other members and borrowers in such local association, *and this liability continues until the loan is paid off and retired during the solvency of such local association.*" (Italics added.)
>
> "Clearly it appears that * * * when appellee retired her loan in the Federal Land Bank * * *, the Western Clay National Farm Loan Association had defaulted in its obligations to the Federal Land Bank, and had been in such default for more than two years prior thereto. *This was a state of insolvency on the part of the local association, and the mere fact that no receivership was procured thereon in no wise alters the situation under consideration. We know of no rule of law, and have been cited none by counsel, which permits a stockholder in an insolvent corporation to withdraw his capital investment at par.*" (Italics added.)

Thus, in both cases where the question has been raised before superior courts, it has been held that the Farm Loan Act contemplates a solvent association, in providing that capital stock shall be paid off at par and retired, when a member has fully repaid the loan which he obtained through the association. This conclusion accords with the prevailing rule respecting the rights of shareholders in building and loan associations—corporations which are strikingly similar, in many respects, to national farm loan associations.

In a line of cases decided before the passage of the Farm Loan Act, the Federal courts had held that the insolvency of a cooperative association suspends the right of its members to withdraw their capital. It must be presumed that, in providing for the withdrawal of capital from national farm loan associations, Congress legislated with knowledge of the rule which the Federal courts had applied to insolvent mutual associations. It must also be presumed that, since national farm loan associations were not expressly excepted from the established rule of the Federal courts in such matters, Congress intended the rule to apply. The cases referred to in this paragraph are discussed below.

An early Federal case, frequently cited in texts and opinions, is *Towle* v. *Am. Bldg. L. & Inv. Soc.* (C. C. Ill.), 61 F. 446. In referring to building and loan associations the court stated:

> "These associations are essentially corporate copartnerships."
>
> "Their officers are the agents of every stockholder."
>
> "The insolvency of such an institution is sui generis. * * * The association is said to be insolvent when it cannot pay back to its stockholders the amount of their actual contributions, dollar for dollar", and in the event of insolvency, borrowing members may not receive credit on their loans, for amounts paid toward stock.

In *Sullivan* v. *Stucky* (C. C. Ind.), 86 F. 491, 493, the court applied the same rule which was announced in the Towle case (*supra*), and held that upon the insolvency of a building and loan association, the borrowing shareholders must pay the full amount owing on their loans. The court pointed out that the application of all payments made by borrowing shareholders to their loan accounts would throw "all the loss on the nonborrowing shareholder, and for that reason

it is unjust and inequitable. Both classes of shareholders ought equally and impartially to bear the burdens arising from the unexpected misfortunes of the enterprise."

A leading case on the subject of insolvent building and loan associations, and the rights of shareholders therein, is *Coltrane* v. *Blake*, (C. C. A. 4th), 113 F. 785. The court reaffirmed the rule of the *Towle* and *Sullivan* cases (*supra*), stating that under "the general law of contracts"—"the law merchant," the insolvency of an association does not release the shareholder from his liability for the full amount of his stock subscription; and that a borrowing shareholder is not entitled to credit on his loan for amounts paid on stock. In its opinion the court stated:

> "A corporation of this character is in one aspect a limited co-partnership. Each stockholder ventures a certain sum of money, the amount of stock subscribed by him."
>
> "Each stockholder stands on the same footing with regard to each share of his stock, and each is liable equally and in the same respect with every other for his subscription, according to the form in which he contracts to pay it * * *."
>
> "All the money so paid under these contracts of [stock] subscription went into the common treasury, in which every stockholder had an interest. This transaction is * * * not dependent for its legality on any local law. It comes within the general law of contracts. If any one, being a stockholder * * * concludes to get from the common treasury money in it, and gets it, * * * it has all the characteristics of a debt for which * * * he is responsible. He hopes to pay this perhaps by the maturity of his stock * * *. The insolvency of the company defeats this hope * * *. But this, of itself, cannot release him from his contract, or free him from his responsibility as a stockholder, or cancel his stock. *The disappointment which he suffers is common with every stockholder in the association. Every stockholder*

> ** * * has paid his subscription, * * * expecting profit at the maturity of the stock in the hoped-for time. The money of each of them has gone into the common fund * * *."* (Italics added.)

In *Aldrich* v. *Gray* (C. C. A. 6th), 147 F. 453, 456, it was held that the receiver of a building and loan association may recover sums paid by the association, during insolvency, to a withdrawing shareholder. In its opinion the court stated:

> *"The current of decisions in this country in regard to this subject seems to be that, when insolvency supervenes in the status of such associations, the right of withdrawal which before existed is suspended, in the absence of some express provision to the contrary. This is the result of the mutuality of the stockholders and the equity of equality, which is of the essence of their relation to each other.* If it were otherwise, and the stockholders could at will successively take their investment out and desert the failing enterprise, those remaining would have to bear the brunt of the joint misfortune." (Italics added.)

See also *Standard Sav. & L. Ass'n* v. *Aldrich* (C.C.A. 6th), 163 F. 216; *Kline* v. *Ariz. Mutual Sav. & L. Ass'n* (C.C.A. 9th), 235 F. 694; *Miles* v. *New South Bldg. & L. Ass'n.* (C.C., La.), 111 F. 946.

In a more recent series of cases, the Federal courts have considered whether withdrawing shareholders of building and loan associations are creditors, within the meaning of the Bankruptcy Act. (Prior to the amendment of February 11, 1932, building and loan associations were subject to involuntary bankruptcy proceedings.) In most of these cases, the courts held that withdrawing shareholders are not creditors, and are not entitled to institute bankruptcy proceedings against the associations.[5] A recent decision of

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[5] *Curtis* v. *Dade Co. Security Co.* (C. C. A. 5th) 30 F. (2d) 325; *In re Guardian Bldg. & L. Ass'n* (D. C. Or.), 53 F. (2d) 412; *In re Puget Sound Sav. & L. Ass'n* (D. C. Wash.), 49 F. (2d) 922.

the Court of Appeals of the District of Columbia in *Fidelity Sav. & L. Ass'n.* v. *Burnet*, 65 F. (2d) 477, 479, 481, throws considerable light upon an apparent conflict respecting this question, between United States Courts in California[6] and in the other districts. The decision, handed down in a tax case, shows that even under the law of California, the shareholder is a creditor only in a very limited sense, and that his claim against the association cannot be enforced until the claims of general creditors have been met. In the course of its opinion the District of Columbia court stated:

> "Speaking generally, building associations are either the 'mutual' or the 'guaranty stock' type. *In case of the former, the basic characteristic is that the association is conducted on the co-operative plan with mutual advantages and benefits to its members who share alike in the profits and losses.* * * * In the case of a mutual association * * * all classes of stockholders vote at stockholders' meetings, share in the earnings, are eligible to office in the corporation, and, *in the event of the insolvency of the corporation and the winding up of its affairs, are entitled only to share in the residue of the assets after the payment of debts.*" (Italics added.)

The stockholder who was before the court "*had, it is true, the advantages of withdrawal which the holder of permanent stock did not have, but this advantage accrued only during the solvency of the corporation.* * * * *had the company become insolvent, he could neither have set off the amount of his subscriptions against his indebtedness to the company nor could he have shared in the assets on an equality with creditors.*

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[6] *Merchants' Nat'l Bank* v. *Continental Bldg. & L. Ass'n* (C. C. A. 9th), 232 F. 828; *In re Western States Bldg.-Loan Ass'n* (D. C. Calif.), 50 F. (2d) 632. In each of those cases, the court held that under the law of California, as previously interpreted by the courts of that State, the holders of "pass-book stock" become creditors (of a subordinate rank) when a building and loan association fails to pay off their stock upon demand.

> His position, though still superior to that of the permanent stockholder, was subordinate to that of the creditor, and therefor until insolvency the character of stockholder continued to exist and the rights of creditor, which in a case of insolvency may be said to arise, applied only to the assets remaining after the payment of the claims of the creditors generally." (Italics added.)

The rule of the Federal courts, with respect to the rights of shareholders upon the insolvency of a mutual association, is the rule of most American jurisdictions, and has met with the approval of text writers. It has repeatedly been held that a member may not withdraw his capital unless the association has a fund with which to pay him; and that until such fund accrues, the shareholder has no right of action against the association. The authorities fully support the following statement in 4 R. C. L. 354:

> "It is obvious that a withdrawing stockholder cannot properly be regarded as having the rights of the ordinary creditor, for if that were so, he might get judgment, issue an execution, acquire a lien upon real estate, and subject the personalty of the Association to the prejudice of other creditors. *He can maintain no suit to recover the withdrawal value of his stock until a fund for its payment has been provided, for until that event has happened, he has no right of action.*" (Italics added.)

The above quoted language is used in *Andrews* v. *Roanoke Bldg. Ass'n. and Inv. Co.*, 98 Va. 445, 36 S. E. 531.

A leading case on insolvent mutual associations is *Heinbokel* v. *National Sav., L. & Bldg. Ass'n.*, 58 Minn. 340, 59 N. W. 1050, where it is said to be obvious that a withdrawing shareholder cannot be regarded as having the rights of an ordinary creditor. In that connection the court stated:

> "It must be remembered that if, upon refusal to pay, because not in funds, a suit may be brought at once,

and prosecuted to judgment, *even if further proceedings could be stayed by the court, such judgment would, as soon as docketed, become a lien upon all real estate, having priority even over a later judgment obtained by a general creditor. In this way a withdrawing member could not only secure superior rights as against the other members, but also over a creditor whose judgment was based upon an independent claim.* In addition to this, the association would be seriously crippled and embarrassed, for no sale of its real property could be made so long as the lien remained. * * * It follows that there must be proper allegations in the complaint and proof upon trial as to the existence of funds out of which payment can properly be made." (Italics added.)

For other authorities sustaining the proposition that the right of withdrawal from a mutual association may be exercised only while the association is a going concern, see: *Endlich on Building Associations; Christian's Appeal*, 102 Pa. 184; *Hale* v. *Cairns*, 8 N. D. 145, 77 N. W. 1010; *Clarke* v. *Olson*, 9 N. D. 364, 83 N. W. 519; *Groover* v. *Pacific Coast Savings Society*, 164 Calif. 67, 127 Pac. 495.

These, and many other cases too numerous to cite, support the observation in *Colin* v. *Wellford*, 102 Va. 581, 46 S. E. 780, 782, that:

"It seems, indeed, to be the accepted American doctrine that, when an association is in fact insolvent, a withdrawing member has only the right to a pro rata share in the distribution of its assets. * * * *The authorities * * * establish the principle that, when insolvency exists as a fact, the right of the shareholders to equality in the distribution of the assets attaches, and constitutes a paramount equity in their favor.*" (Italics added.)

We earnestly submit that the American rule respecting the rights of a withdrawing shareholder upon the insolvency of a cooperative association is applicable to this case.

Under that rule, Respondent never became a creditor of the Knox Association for the par value of his stock. He never had a right of action against the Association, and his rights as a stockholder are limited to a ratable share in the net assets of the Association after its debts have been met.

The courts below erred in entertaining Respondent's suit for the par value of his stock. In granting judgment to Respondent, the courts below ignored the principles of equality and mutuality which must control his relationship to the other shareholders of the Knox Association, and ignored the superior rights of the Association's creditor, the Federal land bank.

3. The Farm Loan Act does not require a Federal land bank to credit the maker of a mortgage note with the proceeds of collateral security owned and pledged by the indorser of the note.

The Act provides (12 U.S.C., § 721) *that when a national farm loan association desires to obtain a loan for any member from the Federal land bank, it shall subscribe for capital stock of the bank to the amount of 5 per cent of the loan, such subscription to be paid in cash upon the granting of the loan.*

> "Such capital stock shall be held by said land bank as collateral security for the payment of said loan, * * * and it shall be paid off at par and retired upon full payment of the mortgage loan. In such case the national farm loan association shall pay off at par and retire the corresponding shares of its stock which were issued when said land bank stock was issued."

The court below quoted the provisions of the Act, and stated:

> "The language of the statutes just quoted is clear, plain and definite. It will be noted that there is no provision under this law whereby the plaintiffs in error [Bank and Association] can escape the definite

requirement that when and if Phillips pays off his mortgage loan that The Knox National Farm Loan Association must pay off his stock at par and retire same. At the same time *the Federal Land Bank is required to pay off at par and retire the corresponding shares of its stock issued in connection with this loan to The Knox National Farm Loan Association, and of course the proceeds should be applied on the borrower's mortgage debt. The law makes no other provision for any other course to be followed no matter whether The Knox National Farm Loan Association is solvent or insolvent.*" (Italics added.) (R. p. 109.)

This interpretation of the Act ignores the plain requirement that "*full payment of the loan*" shall be a condition precedent to the normal retirement of stock pledged as security therefor. Under this interpretation, every borrower who has obtained a loan through a national farm loan association may discharge his debt with less money than his note calls for, and may obtain a release of his mortgage upon paying 95 per cent of the indebtedness ostensibly secured thereby. Every Federal land bank must write off 5 per cent of the original face amount of all mortgage loans made through national farm loan associations, to show their true carrying value as assets.

We cannot disregard this passage of the decision as obiter dictum. Although no judgment was entered against the Bank on the basis of this conclusion, the case remains open for further orders in connection with the administration of the Association's affairs, and the Bank remains a party to the proceeding. It is impossible to anticipate what steps the court and its receiver might deem appropriate to accomplish the result which the appellate court has indicated, in stating that "of course the proceeds [of the Association's stock in the Bank], should be applied on the borrower's mortgage debt."

When respondent commenced this suit, he had not fully repaid the debt which was secured by the Federal land bank's mortgage. He had paid all but 5 per cent of that debt, and had tendered his shares of stock in the association as payment of that balance. The situation remained the same throughout the trial of the case, where respondent contended that he was entitled to a release of his mortgage, on the ground that he had made a valid tender by offering to deliver up the stock in part payment of his debt. This issue was temporarily removed from the case many months later, when the trial court entered its preliminary decree ordering the Bank to release the mortgage upon receipt of cash payment for the balance of 5 per cent ($265). However, the issue was brought back into the case by the appellate court which, in effect, sustained Respondent's original contention as to the validity of his tender of payment.

Since the case remains open for the administration of the receivership, it cannot be presumed that the appellate court directed its remarks merely to a question which had become moot upon cash payment of the full balance of the mortgage debt. On the contrary, it must be presumed that the appellate court's ruling in this regard is in the nature of a general instruction to the lower court for the conduct of the receivership.

In *Federal Land Bank* v. *Crosley* (*supra*), this Court reviewed the provisions of the Farm Loan Act respecting loans through national farm loan associations, and defined the legal relationship of the parties to such loans—borrower, association, and bank. In that case, as in this, the borrower had "executed a promissory note to petitioner [bank], secured by mortgage upon her land, both of which she delivered to petitioner as required by the provisions of the Federal Farm Loan Act." In both cases, "the note, as the statute commands, bore the endorsement of the

agreement of the Association to be liable upon it." In both cases the borrower had subscribed and paid for shares of stock in the association, as required by 12 U. S. C. § 733; and had included the cost of those shares in the loan, as permitted by 12 U. S. C. § 742. In both cases the association had subscribed and paid "for capital stock of the lending federal land bank in like amount," and had pledged that stock with the bank as collateral security for the loan, in conformity with the requirements of 12 U. S. C. § 721. As this Court stated in the *Gaines* case:

> "In the present loan transaction, carried out in strict conformity with the statute, it was plainly contemplated that petitioner was to be the lender, and as lender it was to become the owner of the note and mortgage, in which it was named, respectively, as payee and mortgagee. Respondent, as maker of the note, and the Association, by its endorsement agreeing to be liable for its payment, were both to be obligated to pay the loan. As between the two, the Association was in the position of a surety or guarantor, entitled to be exonerated by the mortgage security and protected to some extent by the 5% stock subscription exacted of respondent. If the transaction were unaffected by the provisions of the Farm Loan Act, it would require no argument or citation of authority to support the conclusion that the delivery of the note and mortgage to the lender, and the receipt of the check from the lender, payable to the obligors upon the mortgage indebtedness, and their endorsement and the collection of it, would establish their liability for the payment of the loan, regardless of what might become of the proceeds."

> "The borrower is under no legal compulsion to borrow. If he takes the benefit of the privilege extended by the statute he can do so only in compliance with its requirement that he shall join, with himself as obligor, the local cooperative association of which he is a member." (Italics added.)

The ruling of the court below squarely conflicts with the foregoing decision. In the *Gaines* case this Court held that the borrower and the Association are both "obligated to pay the loan"—not 95 per cent of the loan. In the present case the lower court has held that the borrower is obligated to pay only 95 per cent of the loan.

In the *Gaines* case this Court held that as between the borrower and the Association, the latter is in the position of a surety or guarantor, entitled to be exonerated by the mortgage security and protected by the borrower's stock subscription. In the present case the lower court has held that as between the borrower and the Association, the latter is in the position of primary obligor for the last 5 per cent of the borrower's loan, and that the borrower is entitled to demand that this payment be made from the proceeds of the stock which the Association purchased from the Bank at the inception of the loan.

In the *Gaines* case this Court held that the borrower's obligation to the lending bank is unaffected by his account with the Association through which the loan was made. In the present case the lower court held that the borrower's obligation to the lending bank is diminished to the extent of his investment in capital stock of the Association.

The court below ignored the corporate entity of the Association, and proceeded on the theory that the Association's member acquired a personal interest and property right in an asset which the Association purchased with funds made available by that member's subscription to stock. This Court has repeatedly disaffirmed that theory, and has stated, as in *Gibbons* v. *Mahon*, 136 U. S. 549, 557:

> "The distinction between the title of a corporation, and the interest of its members or stockholders, in the property of the corporation, is familiar and well settled. *The ownership of that property is in the corporation, and not in the holders of shares of its stock. The interest of each stockholder consists in the right to a pro-*

*portionate part of the profits whenever dividends are declared by the corporation; during its existence under its charter, and to a like proportion of the property remaining, upon the termination * * * of the corporation, after the payment of its debts.*" (Italics added.)

The question involved in the present case was squarely presented in *Federal Land Bank* v. *Warner,* 42 Ariz. 201, 23 P. (2d) 563. (That case came here on writ of certiorari, but the question respecting capital stock was not involved, and was not mentioned in the decision of this Court, 292 U. S. 53.) The case arose upon the foreclosure of a mortgage held by the Federal land bank. The borrower contended that he was entitled to a set-off against his mortgage note, for the amount of his capital stock in the national farm loan association through which the loan had been made. In overruling the trial court which had allowed the set-off, the Supreme Court of Arizona stated:

> Under the provisions of the Federal Farm Loan Act, "the borrower is a stockholder in his association, and * * * his association in turn is a stockholder in the bank. The borrower is not a stockholder in the bank. *The relation he and the bank sustain to each other is that of debtor and creditor and, of course, what he owes the bank cannot be reduced by what the association owes him or may owe him upon a settlement.* The debts are not between the same persons or corporations or their assigns—an essential to the right of set-off or counterclaim." (Italics added.)
>
> "Until the borrower redeems his membership stock in the association by the discharge of the mortgage debt, he certainly has no right to have such stock, or a credit for it. *Before he can claim such shares, he must discharge the debt for the payment of which they were pledged. To the extent of their value, equity will hold and apply the borrower's shares on the debts of the association and the double liability of his fellow stockholders in the association.*" (Italics added.)

In the foregoing case, the Arizona court quoted and relied upon *Byrne* v. *Federal Land Bank* (*supra*), where it was stated:

> "The * * * borrower is a stockholder in the loan association, not in the Federal Land Bank. It is the corporation known as the 'loan association' which is the stockholder in the Federal Land Bank. * * * This relationship is not altered because the law requires additional stock in the land bank to be taken by the loan association * * *."
>
> "The stock taken by the loan association belonged to that corporation, and not to him. Hence the plaintiff has no cause of action against the Federal Land Bank. It is true upon payment of his loan the law required the cancellation of the stock taken in the Federal Land Bank by the Farm Loan Association because of the loan granted to the plaintiff."
>
> "Naturally, upon payment of the loan and the cancellation of the stock in the bank taken by the loan association, the Federal Land Bank would owe the loan association the face value of the stock. * * * the loan association was indebted to the Federal Land Bank at the time the plaintiff's loan was paid, consequently *when the stock was cancelled the value of the stock was used by the land bank as an offset to a portion of the indebtedness of the federal loan association, thus cancelling this portion of the debt. The Federal Land Bank therefore is not indebted to any one on account of stock.*" (Italics added.)

When the present suit was filed and when the testimony was taken, respondent's position was the same as that of the plaintiff in the *Warner* case (*supra*). He had not fully paid his loan. There is not a syllable in the Act which sustains his claim—or the conclusion of the appellate court—that when he has paid all but 5 per cent of his loan, the Bank must credit the balance with the proceeds of collateral pledged by the Association.

The court below has misconceived the purpose which underlies the requirements of the Act for contemporaneous subscriptions to capital stock in connection with loans through national farm loan associations. The court appears to regard these requirements as designed to provide a fund at the Bank, on which the borrower may draw for the purpose of discharging the final payments on his loan (or for the purpose of obtaining a cash rebate of 5 per cent, after he has fully paid the debt). The fallacy of that view is apparent from the Act itself, and is forcibly demonstrated by the legislative history of the Act.

Section 7 of the Act (12 U. S. C. § 722) provides—

> "The capital stock of a Federal land bank shall not be reduced to an amount less than 5 per centum of the principal of the outstanding farm loan bonds issued by it."

Thus, the Act shows that the capital stock of a Federal land bank is required for the protection of its bondholders, and that such stock may at no time be reduced below a stipulated ratio to outstanding bonds. That prohibition is contained in the same section of the Act (§ 7) which provides that stock issued by a Federal land bank in connection with a loan shall be paid off at par and retired upon full payment of said loan (12 U. S. C. § 721). The prohibition, therefore, limits and restricts the Bank by prohibiting the retirement of stock, even in connection with paid-off loans, where the required ratio of stock to bonds would be impaired.

The framers of the Act described capital to be furnished by national farm loan associations as a "cushion" against anticipated losses. During the debates on the floor of the House of Representatives the question was asked—what provision was made to prevent the system from going into bankruptcy. Representative Hayes, a member of the

Joint Committee on Rural Credits which had prepared the bill under consideration, replied as follows:

> "Of course, * * * you cannot prevent by law any system of financial institutions from becoming bankrupt. The only thing that can be done is to provide by law for every possible emergency and to make it as safe as it can be made. That is the attempt here. That is the reason for stock subscription by the borrower and for his liability, * * * in order to make the institution absolutely safe. It has another purpose also. That stock liability * * * in addition makes the loan committee, who are all members of the local association * * * liable for poor loans and for any default on the part of the borrower—it makes them cautious to see to it that they do not make loans that will not be paid back in full by the borrower." (*C. R., 64th Congress, 1st Session, p. 7541.*)

During the debates on the floor of the Senate, it was stated by Senator Hollis who was in charge of the bill:

> "In order to have a successful mortgage-bank system, it is necessary to have a guarantee fund to take up the slack of bad loans. If you just loan the money on the mortgages, and then put up the mortgages as security for an issue of farm-loan bonds, some day there will appear a bad mortgage and you will not have anything to take that out of, * * * and when one drops out you are just so much short.
>
> "Now, it is recognized all over this country and in Europe that in a land-mortgage system you should have a guaranty fund of 5 per cent. You may call it capital. We do in this instance. In this case we have to have a 5 per cent capital, 5 per cent on the amount of our mortgages, 5 per cent on the amount of our bonds. The Government starts out with 12 banks with a capital of $500,000 each, but that would not be enough to support mortgages and bonds of $6,000,000. Therefore we must have some way of getting additional capital in order to impose an issue of bonds

upon it. The only way to do that under a cooperative system, as this is, is to get it from the borrower himself." (*C. R., 64th Congress, 1st Session, p. 6853.*)

In reporting favorably on the measure which was passed, with amendments, as the Federal Farm Loan Act, both the Senate and House Committees on Banking and Currency (*64th Congress, 1st Session, Senate Report No. 144, House Report No. 630*) made substantially the same statements as that quoted below from the report of the Joint Committee on Rural Credits, by which the measure was first proposed:

"Every farm loan bond is secured as follows:

1. By the capital, reserves, and earnings of the land bank which issues it.

2. By the capital, reserves, and earnings of the 11 other land banks.

3. By the collective security of all the mortgages * * * * of the land bank, the mortgages pledged being at least equal in amount to the outstanding bonds.

"Every mortgage pledged as collateral is secured as follows:

1. By the personal undertaking of the borrower.

2. By the security of the mortgaged land * * *.

3. *By the capital, reserves, and earnings of the local association indorsing the loan.*

4. By the individual liability of the members of the indorsing association." (*H. R., Doc. No. 494, 64th Congress, 1st Session,* p. 10.)

It is plain from the Act and from the foregoing statements made while it was under consideration, that the purpose in requiring the purchase and pledge of capital stock was to insure the safety of the bonds which would be

issued by the Federal land banks. "The success of the rural-credit system depends upon the marketability of its bonds" (*H. R., No. 630, 64th Congress*). As this Court pointed out in the *Gaines* case (*supra*):

> "The banks were to make loans to farmers, upon the security of farm mortgages, with funds obtained in large part by the sale to investors of long term bonds. * * * To adapt the system to local needs and to promote cooperation among borrowers, it was proposed that the loans should be made through local associations controlled by their membership."

Meticulous care was taken by the framers of the Act to insure the soundness of that system from the viewpoint of investors. It was felt that without the confidence of those investors, there would be no market for farm loan bonds, and no funds to be loaned on farm mortgage security.

The Act permits a Federal land bank to issue bonds, dollar for dollar, against the security of approved farm mortgages (12 U. S. C. § 841). The Act requires that such mortgages be deposited, as collateral security, with a farm loan registrar who is an officer of the United States (12 U. S. C. § 853). The Act requires the registrar to see that the farm loan bonds issued by any bank and outstanding do not exceed the amount of collateral security pledged therefor (12 U. S. C. § 855), and authorizes the Farm Credit Administration to call upon any bank for additional security to protect the bonds issued by it (12 U. S. C. § 856).

Thus, each Federal land bank is required to deposit and maintain with the farm loan registrar collateral security at least equal in amount to outstanding bonds. Under the theory of the court below, the farm mortgages which constitute the major part of the collateral security, are actually worth less than face value. Under that theory, each mortgage can be discharged by payments aggregating 95 per cent of the original principal of the loan; and the per-

centage of the unpaid balance of each loan which is actually collectible from the borrower becomes progressively less, as he pays successive installments of principal. The theory of the court below is plainly untenable, resulting, as it does, in an impairment of the collateral security which is eligible for farm loan bonds. As this Court stated in the *Gaines* case (*supra*):

> "We should regard as persuasive the fact that a different conclusion would break down the scheme of the Act to make the mortgages taken by the Federal land banks available as collateral for Federal land bank bonds sold to investors."

The record in the present case shows that the Knox Association is indebted to the Bank for an amount which it cannot pay from current assets. The Act requires that the Bank pay off at par and retire the stock issued in connection with paid-off loans. That is, the Bank must retire the stock which the Association has subscribed, and pay the proceeds of such stock to the Association. In the case of the Knox Association, the retirement of stock results in counter-indebtedness—the Association is indebted to the Bank, and the Bank is indebted to the Association for the proceeds of the retired stock. The stock so retired ceases to exist, and in its place the Bank holds the par value of such stock in money, for which it must account to the Association. Thus, there are mutual money demands which may be set off, one against the other. As this Court stated in *Studley* v. *Boylston National Bank*, 229 U. S. 523, 528:

> "Set-off represents the right which one party has against another to use his claim in full or partial satisfaction of what he owes the other. That right is constantly exercised by business men in making book entries whereby one mutual debt is applied against another. * * * Such counterclaims can be asserted

as a defense or by the voluntary act of the parties because it is grounded on the absurdity of making A pay B when B owes A."

In the present case the Bank has the right to set off its debt to the Association, for the proceeds of retired stock, against the Association's debt as indorser of defaulted mortgages. This right is inherent in the Bank's position as the holder of money payable to another, against whom the Bank has a money claim.

Also, the right of set-off is specifically provided for in the Indemnity Agreement between the Bank and the Knox National Farm Loan Association. (R. p. 87.) That agreement provides for an account to which may be credited any moneys otherwise payable to the Association, as an indemnity against any loss which the Bank may suffer in connection with the liquidation of the security for defaulted loans made through the Association.

We earnestly submit that Respondent, as a shareholder of the Knox National Farm Loan Association, had no personal right or interest in the shares of stock which the Association purchased and pledged with the Bank as collateral security for his loan. Those shares of stock constituted an asset of the Association. Upon liquidation of that asset, by retirement of the shares of stock in the Bank, the Association became the Bank's creditor for an amount equal to the par value of the stock—and became immediately subject to the rule of set-off, under which the Bank may and should apply that debt against the Association's debit balance.

There was no privity of contract between Respondent and the Bank with respect to those shares. Respondent has at no time been a shareholder of the Bank. The Association has been the Bank's shareholder, and Respondent has no individual property right growing out of the Association's subscription to any shares of Bank stock.

To allow Respondent any claim against the proceeds of stock of the Bank which was issued to the Association would be to reverse the plain intent and purpose of the Farm Loan Act, which provides that the shareholders of every national farm loan association shall be held individually responsible, equally and ratably, for all contracts, debts and engagements of such association to the extent of the amount paid in and represented by their shares of stock.

4. The Association did not agree to confer upon Respondent the status of creditor for the amount of his capital subscription, and any contract purporting to confer such status would have been ultra vires and unenforceable.

The court below held that Respondent "is both a creditor and a stockholder" of the Association, and approved the judgment of the trial court partly because of "the definite agreement and promise of the Knox National Farm Loan Association, to the effect that upon final payment of the loan the stock held by Phillips was to be paid off at par." The "agreement" to which the court referred (R. p. 71) is quoted below.

> "Receipt for Stock Held by Knox National Farm Loan Association.
>
> "This acknowledges that there has been this date issued to A. C. Phillips, a member of Knox National Farm Loan Association of Mt. Vernon, State of Ohio, Certificate No. 93 for 53 shares of Capital Stock of the par value of $5 in the above-named Association.
>
> "This stock is issued in connection with the loan of $5300.00 made through this Association * * *. This stock is being held by this Association pursuant to the provisions of the Federal Farm Loan Act as collateral security for the payment of the loan * * *.
>
> * * * * * * * *

*"This receipt represents your investment in stock on which dividends will be paid. It will be accepted at face value on final payment of loan. * * *" (Italics added.)*

That document is not an agreement at all. It is entitled "Receipt for Stock Held", etc., and is so designated in its concluding paragraph. It is a mere unilateral receipt for a deposit of collateral. It does not purport to state the terms of the agreement under which the collateral was pledged, except by reference to the Federal Farm Loan Act.

The instrument states that the collateral is a stock certificate—a contract in and of itself; that the stock was issued "in connection with" a certain loan "made through this Association"—a contract in and of itself; and that the stock is being held by the Association as collateral security, "pursuant to the provision of the Federal Farm Loan Act." Thus, the instrument shows on its face that the rights and obligations of the parties to the collateral pledge are controlled by the Act; and that the rights and obligations of the parties to the several contracts are controlled by the contracts themselves.

Among other recitals which describe the collateral and the incidents of ownership are the statements: "stock on which dividends will be paid"; and "it will be accepted at face value on final payment of loan." These statements are of equal dignity. Yet the court below found a definite promise and agreement in the words "will be accepted", without attributing any such significance to the words "will be paid" in the preceding sentence of the receipt. Obviously, the court could not have found an enforceable contract to pay dividends, both because there was no stipulation as to the rate and date of such payments, and because the association may pay dividends only when properly declared by the board of directors, and approved by the Farm Credit Administration (12 U. S. C. § 913). Though posi-

tive in form, the recital as to dividends is susceptible of one interpretation only, that is: Dividends will be paid upon the stock if and when lawfully declared by the board of directors of the Association. The correctness of that interpretation has been tacitly conceded throughout this case, by Respondent's failure to make any claim for dividends.

The words "will be accepted" must be construed in the same manner when used in the following sentence of the same instrument. That is: The receipt will be accepted (redeemed in cash) at face value on final payment of the loan, if, at that time, the Association can lawfully pay off stock at par.

These words are merely descriptive of benefits which Respondent may expect to derive from his subscription to capital stock. As a shareholder, Respondent has no right to withdraw his capital when the Association is insolvent. Since the Receipt for Stock does not purport to create new rights, it does not purport to confer upon Respondent any such right of withdrawal.

Even if an absolute and unqualified promise were made by the words "will be accepted at face value", the instrument shows on its face that there was no consideration for any such promise, and that no right of action can be based thereon.

However, let us assume, for the moment, that the "Receipt for Stock" contains a definite promise and agreement that respondent's stock is "to be paid off at par" upon final payment of his loan, regardless of the solvency or insolvency of the Association. Let us also assume, as the court below must have done, that consideration for that agreement is evidenced by the instrument itself. Such an agreement would enlarge the rights which Respondent acquired when he became a member and shareholder of the association. It would vary the terms of his statutory contract of membership. It would be void and unenforceable, because

the Association has no power to contract with its member for the redemption of his stock on any other basis than that prescribed by the Act.

Under the Act, Respondent and all other shareholders of the Association are liable, equally and ratably, for all contracts, debts and engagements of the Association to the extent of the amount of stock owned by them. (12 U. S. C., § 744.) Respondent's contract as a shareholder includes that provision of law. As this Court stated in *Richmond v. Irons*, 121 U. S. 27, 55 (quoted in *Matteson v. Dent*, 176 U. S. 521, 526):

> "Under the act the individual liability of the shareholders is an essential element of the contract by which the stockholders became members of the corporation. It is voluntarily entered into by subscribing for and accepting shares of stock. Its obligation becomes a part of every contract, debt, and engagement of the bank itself, as much so as if they were made directly by the stockholder instead of by the corporation."

The Association is not authorized to abrogate the individual liability clause of its contract with any member, by a collateral agreement to recognize him as a creditor, whenever he elects to withdraw his stock subscription. Any agreement to that effect would be ultra vires and void.

It has repeatedly been held that collateral agreements are void and unenforceable, when entered into by mutual associations for the purpose of preferring one shareholder over others. In *Kline v. Ariz. Mut. Sav. & L. Assn.* (C. C. A. 9th), 235 F. 694, an insolvent association had procured the delivery of secured notes to a withdrawing shareholder, for the par value of his stock. In refusing to enforce the secured notes issued to the shareholder, the court stated:

> "To sustain the appellant's exclusive claim to them [the collaterals] would be to subordinate to that extent

the rights of all other stockholders of the insolvent association, which would be manifestly contrary to the well established law upon the subject." (L. C. 701.)

In *Standard Savings and Loan Ass'n.* v. *Aldrich* (C. C. A. 6th), 163 F. 216, an insolvent association had borrowed money in order to satisfy the demands of withdrawing shareholders. This purpose was known to the lender. The court refused to enforce the loan contract against the insolvent association. The opinion in the case (written by Mr. Justice Lurton, then circuit judge) contains a clear and forceful discussion of the obligations of shareholders in mutual associations.

"The power to borrow money to pay off withdrawing stockholders cannot be legitimately inferred or implied. * * * *The withdrawal of a shareholder is the withdrawal of capital pledged primarily to creditors and to carry on the business for which the association was organized. The funds applicable therefore to the payment of withdrawing shareholders is the fund arising from the current contributions of a solvent and going association, and no other funds can be legitimately so applied.* This we think plain from the relation of shareholders to such associations * * *." (Italics added.) (l. c. 219.)

"Such a borrowing would not be for the purpose of paying debts and liabilities in due course of business. * * * Appellants * * * had notice that the borrowing was for the payment of withdrawing shareholders and are constructively charged with knowledge that the managers were acting without power in so doing and in assigning the mortgages of borrowing shareholders to secure the loan. *A contract beyond the scope of the power of the * * * Association, express or implied, cannot be enforced by an appeal to the rules of estoppel. Any such application of the doctrine would be, in effect, to enlarge the power of the corporation in accordance with the discretion of its managers, vio-*

lating thereby the rights of innocent shareholders and a sound public policy." (Italics added.) (l. c.-220.)

"* * * *the Association was insolvent at the time. This fact, without more, suspended the power and right of the directors to apply any funds to the payment of withdrawing shareholders.*" (Italics added.) (l. c. 220.)

"*If this [borrowed] money was applied to pay off withdrawing stockholders, the association has not been benefited.*" (Italics added.) (l. c. 223.)

The above quoted opinion cites the following decisions of this Court holding that an ultra vires contract will not support an action: *Central Transportation Co.* v. *Pullman's Palace Car Co.*, 139 U. S. 24, 60; *Railway Co's.* v. *Keokuk Bridge Co.*, 131 U. S. 371, 389; *McCormick* v. *Market Bank*, 165 U. S. 538, 549; *Calif. Bank* v. *Kennedy*, 167 U. S. 363, 368. (See also: *Awotin* v. *Atlas, etc. Nat. Bank*, 295 U. S. 209.)

The effect of withdrawal from a cooperative association is the same as the effect of a monied corporation's purchase of its own stock. The Circuit Court of Appeals for the Second Circuit (*In re Fechheimer Fishel Co.*, 212 F. 357) held that where a solvent corporation agrees to purchase its own stock, and thereafter becomes insolvent, the contract is unenforceable. The corporation involved in that case had issued "debenture bonds" which were, in reality, preferred stock. The holder of one of these "debenture bonds" surrendered it in exchange for the corporation's promissory note for the face amount of the instrument; and upon the maturity of the note, a renewal note was given by the corporation. Thereafter, the corporation was adjudicated bankrupt, and the payee of the renewal note filed his claim as a creditor. The bankruptcy court held that the payee's right were those of a shareholder. In sustaining that decision, the Circuit Court of Appeals said:

"A solvent corporation, of course, holds its property as any individual holds his. But when a corporation becomes insolvent, a trust arises in respect to the administration of its assets for the benefit of its creditors. * * * *Hence when a corporation buys its own stock payment cannot be made with funds which upon insolvency belong to its creditors instead of to its stockholders. Cook on Corporations* (7th Ed.), vol. 1, § 9, pp. 42, 43." (Italics added.) (l. c.-364.)

"The stock of a corporation is its only basis of credit, and it is of vital importance that it be rigidly guarded and protected. Courts have conceived it to be their duty to detect and defeat any scheme or device calculated in any way to place this fund beyond the reach of the creditors. * * * As the illegality of a purchase by a corporation of its stock rests upon the fact that it withdraws assets upon which the creditors have a superior right or lien, it seems to us that even though the company may have been solvent when the contract to purchase was made, if it becomes insolvent later or is made insolvent by the transaction and is in that condition at the time when payment is to be made, the vendor cannot as against creditors be permitted to take the assets for that purpose * * *. In the case at bar, when the corporation bought the stock and gave its note to Rothenberg, it in effect promised to pay him $50,000 out of surplus profits and if payment could be made without prejudice to creditors. To be sure the note did not so state on its face, but that was a condition which the law attached to it and which was binding on both Rothenberg and the company." (l. c.-365.)

In *Keith* v. *Kilmer* (C. C. A. 1st), 261 F. 733 (certiorari denied, 252 U. S. 578), it was held that the stockholder of a corporation may not "be transmuted from a stockholder into a creditor, and as such be permitted to share in the assets" by an executory contract between himself and the corporation. In that case, a corporation had contracted with certain shareholders to purchase their stock. There-

after the corporation became insolvent, and the shareholders filed claims as creditors, based upon the contract. The court cited *In re Fechheimer Fishel Company* (*supra*) and other Federal and state cases holding that a corporation's agreement to pay for its own stock cannot be enforced to the injury of creditors—such agreement being the equivalent of a contract to diminish its capital; and that the stockholders of a corporation hold their stock subject to all the equities which attach.

In *Warren* v. *King*, 108 U. S. 389, this Court construed certificates for preferred stock, which had been issued to former creditors upon the reorganization of a railroad corporation. The reorganized corporation became insolvent, and the holders of this preferred stock contended that their certificates entitled them to a lien upon all property and franchises of the company, superior to the claims of creditors. In overruling that contention, this Court stated:

> "But it is stock, and part of the capital stock, with the characteristics of capital stock. One of such characteristics is, that no part of the property of a corporation shall go to reimburse the principal of capital stock until all the debts of the corporation have been paid. It would require the clearest language to admit of the application of a different rule to any capital stock." (l. c.-396.)
>
> "His chance of gain, by the operations of the corporation, throws on him, as respects creditors, the entire risk of the loss of his share of the capital, which must go to satisfy the creditors in case of misfortune. *He cannot be both creditor and debtor, by virtue of his ownership of stock.*" (Italics added.) (l. c.-399.)

In *Spencer* v. *Smith* (C. C. A. 8th), 201 F. 647, 655, it was held that a provision in a stock certificate would be void as against public policy, if it were construed as allowing the

corporation to pay preferred stockholders ahead of creditors.

Warren v. *King* (*supra*) was quoted by Mr. Justice Lurton, in the opinion which he wrote for the Circuit Court of Appeals for the Sixth Circuit in *Hamlin* v. *Toledo etc. R. Co.* (C. C. A. 6th), 78 F. 664, 670, 671, where it was stated:

> "There is a wide difference between the relation of a creditor and a stockholder to the corporate property. *One cannot well be a creditor as respects creditors proper, and a stockholder by virtue of a certificate evidencing his contribution to the capital of the corporation.* Stock is capital, and a stock certificate but evidences that the holder has ventured his means as a part of the capital." (Italics added.)
>
> "If the purpose in providing for these peculiar shares was to arrange matters so that, under any circumstances, a part of the principal of the stock might be withdrawn before the full discharge of all corporate debts, the device would be contrary to the nature of capital stock, opposed to public policy, and void as to creditors affected thereby."
>
> Capital stock "*is a liability which is postponed to every other liability, and no part of the capital stock can be lawfully returned to the stockholders until all debts are paid or provided for. The violation of this well-understood principle is a breach of trust, and a creditor affected thereby may pursue the stockholders, and recover as for an unlawful diversion of assets.*" (Italics added.)

The rule of the foregoing cases has been reversed in the present suit. The courts below have construed Respondent's "Receipt for Stock" as an executory contract by which the Association agreed to pay off its stock at par when Respondent had fully repaid his loan; and both courts have held that this executory agreement is enforceable against the

Association, even though, at the date of performance, the Association is insolvent.

We earnestly submit that, when Respondent's "Receipt for Stock" is construed in the light of the authorities, the following conclusions are inevitable: (1) the instrument does not purport to be and is not an executory agreement; (2) any promissory language in the instrument must be read, if possible, as including an implied reference to the limitations and conditions of the Farm Loan Act; and (3) if the instrument contains promissory provisions which are inconsistent with the limitations of the Act, such provisions are unenforceable and void.

5. A national farm loan association is an instrumentality of the United States, and jurisdiction to wind up such association, upon insolvency, is vested exclusively in the Farm Credit Administration.

This Court has repeatedly held that a Federal land bank is an instrumentality of the Government of the United States, created and operated for a public purpose pursuant to a valid act of Congress. *Smith* v. *Kansas City Title and Trust Co.* (*supra*); *Federal Land Bank* v. *Gaines* (*supra*); *Federal Land Bank* v. *Crosland*, 261 U. S. 374; *Federal Land Bank* v. *Priddy*, 295 U. S. 229.

The national farm loan association is an integral part of the Federal land bank system. It is the local unit. The association and the bank are coordinate agencies, each designed to perform related functions as instrumentalities of the Federal Government. The facilities and services of the association are required from the inception of every loan which it recommends, to the final liquidation of that loan. Every act which the association takes in connection with a loan is in furtherance of the safety and security of a mortgage which is "an instrumentality of the Government of the United States." (12 U. S. C. §931.)

The general corporate powers conferred upon Federal land banks, including the power "to have succession until * * * dissolved by Act of Congress, or under the provisions of this chapter" (12 U. S. C. §676, Second) have, so far as may be applicable, been granted to national farm loan associations (12 U. S. C. §716). The provisions for liquidation of insolvent national farm loan associations have been made applicable to Federal land banks (12 U. S. C. §963).

This Court has recognized that a corporation or other enterprise may become a Federal instrumentality, by virtue of its connection with an agency of the Federal Government. In the very recent case of *Rogers* v. *Graves* (decided January 4, 1937), it was pointed out that the Panama Canal is an instrumentality for the regulation of interstate and foreign commerce, and that the operation of the canal is a Government function.

> "Such being the status of the canal, it requires no argument to demonstrate that all auxiliaries primarily designed and used to aid in its management and operation, and which have that effect, partake of its nature and are themselves cooperating regulators—or, perhaps more accurately speaking, constitute, with the canal, a single great regulator—of national and international commerce. And this, we think is the effect of the interrelation of the railroad company's activities with the management and operation of the canal."
>
> "* * * the railroad itself, in connection with the canal, is a federal instrumentality."

The operations of the Federal land bank are geared to the existence and functioning of the associations of its district. The bank's stock is owned by these associations which have voice in the bank's management, through the directors whom they elect. In short, the associations are instrumentalities which were deemed appropriate by Congress to

the end of establishing and maintaining the Federal land banks as effective public agencies.

In the *Gaines* case (*supra*) this Court stated that both the Federal land banks and the national farm loan associations are, "in a broad and general sense, public agencies or instrumentalities to carry out a policy of Government—the extension of credit to those engaged in agriculture to be availed of in the furtherance of agricultural undertakings." This passage of the *Gaines* decision appears to affirm—as equally applicable to banks and associations—the proposition which was advanced in the brief filed on behalf of the Federal Land Bank of Wichita in *Smith* v. *Kansas City Title and Trust Co.* (*supra*), that:

> "The Federal Land Banks * * * constitute facilities and instrumentalities for the use of money for a public purpose of great importance; and it was clearly within the authority of Congress, either to appropriate money or to issue Government bonds and apply the proceeds directly through the Treasury Department to the end in view, or to create these facilities and instrumentalities as appropriate means to the same end."

Whether the Association—a Federal instrumentality—is subject to suit, and if so to what extent, is a question which must be determined in the light of the Federal Farm Loan Act—the organic law by which Congress authorized the creation of the corporation, and defined its powers, duties and liabilities. This Court stated in *Van Reed* v. *People's Nat'l Bank*, 198 U. S. 554, 557:

> "*The right of Congress to determine to what extent a state court shall be permitted to entertain actions against national banks * * * is undeniable.*" (Italics added.)

In stating the powers of a national farm loan association (12 U. S. C. § 761), the Act is silent with respect to the

association's capacity to sue and be sued. However, the Act provides (12 U. S. C. § 761) that the incorporators shall "organize subject to the requirements and conditions specified" in 12 U. S. C. §§ 671-683, which relate to Federal land banks. In 12 U. S. C. § 676, Federal land banks are empowered "to sue and be sued, complain, interplead, and defend, in any court of law or equity, as fully as natural persons." These two provisions of the Act have always been read together, as authorizing suits by and against national farm loan associations.

If the foregoing provisions stood alone, without any qualifications or restrictions imposed by other sections of the Act, they might be construed as authorizing a court of equity to appoint a liquidating receiver for a national farm loan association, in a proper case. *Pennsylvania* v. *Williams* and related cases, 294 U. S. 176, *et seq.; Federal Land Bank* v. *Priddy*, (*supra*). However, the Act prescribes a special procedure for winding up an association. When Congress provided for an administrative receivership, the entire matter of liquidation was withheld from the jurisdiction conferred upon the courts by the "sue and be sued" clause. To paraphrase the language of this Court, the result is that *all the receivership laws of the State must be read as if they contained a provision in express terms that they were not to apply to suits against a national farm loan association.* (*Van Reed* v. *People's National Bank, supra*, l.c. 558.)

The Farm Credit Administration has plenary authority to wind up insolvent corporations of the land bank system. That authority is conferred by § 29 of the Federal Farm Loan Act (12 U. S. C. §§ 961-966). When any land bank or national farm loan association has "failed to meet its obligations of any description," it may be declared insolvent and wound up forthwith. The receiver must thereupon proceed

under the direction and control of the Farm Credit Administration. The prescribed method of liquidation is full, complete and adequate. The provisions of the Act are inconsistent with any other mode of involuntary liquidation, and the Act prohibits voluntary liquidation without the consent of the Farm Credit Administration. (12 U. S. C. § 965.)

In *Wheeler* v. *Greene,* 280 U. S. 49, this Court pointed out that the provisions of the Federal Farm Loan Act dealing with insolvency of farm loan associations (12 U. S. C. § 961, *et seq.*) "closely follow the words of the earlier National Bank Act, R. S. § 5234; Code, Tit. 12, § 192, stating the duties of the receiver of a bank * * *, and giving him power to take possession of books and assets and to collect debts, etc." The Court referred to the receivership provisions of the National Banking Act as the "prototype" or "model," and the provisions of the Farm Loan Act as the "copy." The striking similarity of these provisions is apparent from the following analysis:

National Banking Act.	Federal Farm Loan Act.
12 U. S. C. § 191.	12 U. S. C. § 961.
"Whenever * * * the comptroller shall become satisfied of the insolvency of a national banking association, he may, after due examination of its affairs, * * * appoint a receiver who shall proceed to close up such association * * *."	"Upon receiving satisfactory evidence that any national farm loan association has failed to meet its outstanding obligations of any description, the Farm Credit Administration may forthwith declare such association insolvent and appoint a receiver
12 U. S. C. § 192.	
"the Comptroller of the Currency may * * * require of him [the receiver] such bond and security as he deems proper. Such receiver, under the direction of the comptroller, shall take possession of the books, records, and assets of every description of such association, collect all debts, dues, and claims belonging to it, and, upon the order of a court of record of competent jurisdiction, may sell or compound all bad or doubtful debts, and, on a like order, may sell all the real and personal property of such association, on such terms as the court shall direct * * *.	and require of him such bond and security as it deems proper * * *. Such receiver, under the direction of the Farm Credit Administration, shall take possession of the books, records, and assets of every description of such association, collect all debts, dues, and claims belonging to it, and, with the approval of the Farm Credit Administration, or upon the order of a court * * * of competent jurisdiction, may sell or compound all bad or doubtful debts, and, on a like approval or order, may sell all the real and personal property of such association, on such terms as the Farm Credit Administration or said court shall direct.

National Banking Act—Continued.

12 U. S. C. § 192.

Such receiver shall pay over all money so made to the Treasurer of the United States, subject to the order of the comptroller, and also make report to the comptroller of all his acts and proceedings.

"*Provided*, That the comptroller may, if he deems proper, deposit any of the money so made in any regular Government depositary, or in any State or national bank either of the city or town in which the insolvent bank was located, or of a city or town as adjacent thereto as practicable; if such deposit is made he shall require the depositary to deposit United States bonds or other satisfactory securities with the Treasurer of the United States * * *. Such depositary shall pay upon such money interest at such rate as the comptroller may prescribe * * *."

12 U. S. C. § 194.

"From time to time, after full provision has been first made for refunding to the United States any deficiency in redeeming the notes of such association, the Comptroller shall make a ratable dividend of the money so paid over to him by such receiver on all such claims as may have been proved * * *; and the remainder of the proceeds, if any, shall be paid over to the shareholders of such association * * *."

Federal Farm Loan Act—Continued.

12 U. S. C. § 962.

Such receiver shall pay over all money so collected to the Treasurer of the United States, subject to the order of the Farm Credit Administration, and also make report to said administration of all his acts and proceedings.

"The Secretary of the Treasury shall have authority to deposit at interest any money so received."

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12 U. S. C. § 964.

"If any national farm loan association shall be declared insolvent and a receiver shall be appointed therefor by the Farm Credit Administration, the stock held by it in the Federal land bank of its district shall be canceled without impairment of its liability and all payments on such stock * * * shall be first applied to all debts of the insolvent farm loan association to the Federal land bank and the balance, if any, shall be paid to the receiver of said farm loan association: *Provided*, that in estimating said debts contingent liabilities incurred by national farm loan associations * * * on account of default of principal or interest of indorsed mortgages shall be estimated and included as a debt, and said contingent liabilities shall be determined by agreement between the receiver and the Federal land bank of the district, subject to the approval of the Farm Credit Administration, and if said receiver and said land bank cannot agree, then by the decision of the Land Bank Commissioner, and the amount thus ascertained shall be deducted in accordance with the provisions of this section from the amount otherwise due said national farm loan association for said canceled stock."

55

This Court has repeatedly held that national banks are withdrawn from the application of general law, both with respect to operation and winding up, to the extent that such matters are covered by the National Banking Act. In *Cook County National Bank* v. *United States*, 107 U. S. 445, 448, the Act was said to constitute "by itself a complete system for the establishment and government of national banks," including—

> "their liability to be placed in the hands of a receiver, and the manner, in such event, in which their affairs shall be wound up, their circulating notes redeemed, and other debts paid or their property applied towards such payment. Everything essential to the formation of the banks, the issue, security, and redemption of their notes, *the winding up of the institutions, and the distribution of their effects, is fully provided for, as in a separate code by itself, neither limited nor enlarged by other statutory provisions with respect to the settlement of demands against insolvents or their estates.*" (Italics added.)

In the above-quoted case it was held that the provisions of the National Banking Act, for ratable distribution of assets among creditors, have the effect of withdrawing insolvent national banks from the general provisions of law which give the United States preference over all other creditors, in the event of insolvency. On this point the court stated:

> "* * * *a law embracing an entire subject, dealing with it in all its phases, may thus withdraw the subject from the operation of a general law as effectually as though, as to such subject, the general law were in terms repealed."

In *Easton* v. *Iowa* (1902), 188 U. S. 220, 231, 238, this Court held that the officers of a national bank cannot be prosecuted for violation of a state law prohibiting the ac-

ceptance of deposits during insolvency. In its opinion the court stated:

> "* * * Congress has provided a symmetrical and complete scheme for the banks to be organized under the provisions of the" National Banking Act.
>
> "*Congress has directly dealt with the subject of insolvency of such banks by giving control to the Secretary of the Treasury and the Comptroller of the Currency, who are authorized to suspend the operations of the banks and appoint receivers thereof when they become insolvent* * * *; full and adequate provisions have been made for the protection of creditors of such institutions by requiring frequent reports to be made of their condition, and by the power of visitation by Federal officers; * * * *it is not competent for state legislatures to interfere, whether with hostile or friendly intentions, with national banks or their officers in the exercise of the powers bestowed upon them by the general government.*" (Italics added.)

In *Davis* v. *Elmira Savings Bank*, 161 U. S. 275, 283, this Court held that the National Banking Act controls the distribution of the assets of an insolvent national bank, and that a state law is inoperative to confer a preference upon certain creditors. In its opinion the Court said:

> "National banks are instrumentalities of the Federal government, created for a public purpose, and as such necessarily subject to the paramount authority of the United States. It follows that an attempt, by a State, to define their duties or control the conduct of their affairs is absolutely void, wherever such attempted exercise of authority expressly conflicts with the laws of the United States, and either frustrates the purpose of the national legislation or impairs the efficiency of these agencies of the Federal government to discharge the duties, for the performance of which they were created. These principles are axiomatic, and are sanctioned by the repeated adjudications of this Court."

It is apparent from the two cases last cited that this Court has recognized the National Banking Act as the paramount and exclusive law, both with respect to the substantive rights of interested parties in the assets of an insolvent bank, and with respect to the remedy of liquidation by an administrative receivership.

This Court has held that the remedy afforded by the National Banking Act is exclusive, in so far as it concerns the enforcement of the personal liability of shareholders. In *Kennedy* v. *Gibson*, 8 Wall. 498, the statutory receiver of a national bank brought suit against certain shareholders to enforce their personal liability. The defendants demurred on the ground that the complaint failed to show action by the Comptroller of the Currency, determining that a deficiency existed, etc. This Court held that the demurrer was properly sustained, because—

> "It is for the comptroller to decide when it is necessary to institute proceedings against the stockholders to enforce their personal liability, and whether the whole or a part, and if only a part, how much, shall be collected. These questions are referred to his judgment and discretion, and his determination is conclusive. * * * He may make it at such time as he may deem proper, and upon such data as shall be satisfactory to him. This action on his part is indispensable, whenever the personal liability of the stockholders is sought to be enforced, and must precede the institution of suit by the receiver." (l. c.-505.)
>
> "Creditors must seek their remedy through the comptroller in the mode prescribed by the statute; they cannot proceed directly in their own names against the stockholders or debtors of the bank." (l. c.-506.)

It is significant to note, in connection with this decision, that the Comptroller's authority rests upon the statutory provision that he "*may*, if necessary to pay the debts of such association, enforce the individual liability of the stock-

holders'' by his receiver. The conclusion is evident that, when a national bank becomes insolvent, the remedies expressly afforded by the National Banking Act are the only available remedies, and exclude any other mode of procedure.

The courts have for many years proceeded upon the assumption that power to wind up a national bank was vested exclusively in the Comptroller of the Currency, by the provisions of the National Banking Act which authorize administrative receiverships. In *Boyd* v. *Schneider* (C. C. A. 7th), 131 F. 223, 227, it was stated:

> "The national banking act provides a system for the collection of the assets of an insolvent bank, and their distribution among creditors. *The legal machinery for this is a receiver appointed by the comptroller of the currency, and removable by him, in whom is vested all rights of receivership, to the exclusion of all other receivers or assignees * * *. It substitutes for the bank solvent, the machinery provided for the bank insolvent.*" (Italics added.)

In the same case it was stated that the insolvency provisions of the National Banking Act "will exclude all other forms of administration" (citing *Kennedy* v. *Gibson* (*supra*); *In re Manufacturers' Nat'l. Bank* (D. C., Ill.), Fed. Cas. No. 9051, 16 F. Cas. 665; *Washington Nat'l. Bank* v. *Eckels* (C. C.) 57 F. 870; and *Pahquioque Bank* v. *Bethel Bank*, 36 Conn. 325, 4 Am. Rep. 80), and that—

> "These cases hold that national banks cannot, at the suit of creditors, be thrown into bankruptcy, or their affairs wound up in accordance with the statutes of states providing for the winding up of corporations. * * * *proceedings to wind up, and bankruptcy proceedings, are essentially administrative. No one doubts the power of congress to provide the machinery for such administration, and no one doubts the intention of*

> *congress, in the enactment of the national banking act, that to the extent national banks* were concerned, such machinery should be embodied in the powers conferred upon the comptroller." (Italics added.)

In passing upon the same case, the Circuit Court stated (*Boyd* v. *Schneider*, 124 F. 239, 242):

> "It would seem that the powers given by the statute to the Comptroller are in their nature judicial. He can determine when a bank is insolvent. He alone is charged with the duty of enforcing compliance with the provisions of the law * * *. He must, through the receiver, take possession of all the bank's assets, collect and compromise debts, and sell the real estate. *He alone can determine the need of and appoint a receiver.* The receiver must pay the moneys collected by him to the Treasurer of the United States, subject to the order of the Comptroller. * * * *All these questions are referred to his judgment and his discretion.*" (Italics added.)

In *Liberty Nat'l. Bank* v. *McIntosh* (C. C. A. 4th), 16 F. (2d) 906, it was stated that the jurisdiction of the Comptroller over insolvent national banks "in respect to all matters properly within his discretion is exclusive, and he is in respect thereto in no manner amenable to any court, nor is his action subject to review therein."

A particularly helpful decision on the jurisdictional question is *In re Manufacturers' Nat'l. Bank* (*supra*). That case (decided in 1873) arose upon an involuntary petition in bankruptcy filed against a national bank. It was held that the Bankruptcy Act did not apply to national banks, and that the bankruptcy court was without jurisdiction.

> "The bankrupt law is the latest expression of the legislative will, and its general terms and provisions must be held to repeal all previous statutes necessarily incompatible with it. The question then is, does the

bankrupt law repeal and supersede the provisions in the currency act for winding up the affairs of insolvent national banks? or can its provisions be applied to those corporations and leave intact the provisions of the currency act on the same subject?''

The court answered both questions in the negative, holding that the Bankruptcy Act neither repealed the insolvency provisions of the National Banking Act nor established a concurrent remedy. In concluding that Congress intended the provisions of the National Banking Act to be exclusive, the court stated in part:

> ''It will thus be seen that while the currency act does not specify in detail, and provide for all the specific acts of bankruptcy enumerated in the bankrupt law, it yet does furnish, through the functions of an important public officer—the comptroller of the currency—a very complete and detailed scheme or plan for administering the affairs of an insolvent national bank. It is true there is no provision for an individual creditor's putting this machinery in motion. But the presumption is that congress deemed it wiser to leave this duty to an impartial public officer rather than entrust it to the hasty, inconsiderate, and perhaps selfish action of one or more creditors. * * * At all events, the law as it was enacted contained ample and specific provisions for creating and managing these corporations, and for administering their affairs when they became unable or refused to perform their public functions.''

The Court held that the remedies given by the Bankrutcy Act and by the National Banking Act were not concurrent. One this point the Court stated:

> ''* * * such a construction would inevitably produce collisions and conflicts of jurisdiction, and the remedies given by the bankrupt act would be so far unavailing in regard to important assets as to make it evident that there was no intention to apply such a

> remedy. Suppose this court were to adjudge this respondent bankrupt to-day, and send its messenger and assignee to take possession of the assets, the officer of the court could in no event * * * obtain possession of the government bonds deposited to secure the circulation, or any surplus of those bonds after fully redeeming the circulation. Those assets are beyond the reach of this court or its officers, and can only be approached by the way of the comptroller and his receiver. Then why should this court take cognizance of a case that it cannot administer?
>
> "Why not, rather, say that congress has acted upon the subject matter of insolvent national banks and made specific provisions for administering their affairs, and, inasmuch as the general bankrupt law has not expressly repealed these specific provisions nor necessarily suspended them, the courts will presume it was the intention of congress to except this class of corporations from the operation of the later statute? Such conclusion seems to me consistent with authority, and is, in fact, the only conclusion that will not lead to inextricable complication and conflict."

Sharper "collisions and conflicts of jurisdiction" would result if the Ohio court should proceed with its attempted liquidation of the Knox Association.

The national bank (in the case just above referred to) had deposited collateral security for its circulating notes, which could be reached "only by the way of the comptroller and his receiver." The Knox Association has deposited collateral security for indorsed mortgages which can only be reached by way of the Farm Credit Administration and its receiver (12 U. S. C. § 964).

The Federal Land Bank holds the collateral deposited by the Association—nearly $25,000 in bank stock. If the Association is declared insolvent and placed in the hands of a receiver, the Bank must cancel this stock, and apply

the proceeds in the manner prescribed by the Act (12 U. S. C. § 964).

The Federal Land Bank is in a highly equivocal position. It is a party to the suit in which the Ohio court appointed a receiver to liquidate the Association. The Bank remains a party for the purpose of any further "orders in respect to the Receivership" which the court has reserved the right to issue. The Bank is bound by the decree enjoining interference with the court's receiver, and requiring that all assets of the Association be delivered up to him. (R. pp. 99-101.)

The Bank holds the principal asset of the Association—nearly $25,000 in bank stock. The court has ordered the Bank to surrender the asset. The Farm Loan Act prohibits such surrender, and directs the bank to liquidate the asset and retain the proceeds, to the extent necessary (1) to satisfy all debts owing by the association to the bank; and (2) to cover the contingent liabilities of the association for defaults under indorsed loans. The amount thus to be retained and the balance, if any, to be paid over to the association's receiver is to be determined upon agreement between the receiver and the bank, subject to the approval of the Farm Credit Administration. If an agreement cannot be reached, the determination must be made by the Land Bank Commissioner. (12 U. S. C. § 964.)

The court has authorized its receiver to collect and liquidate the assets of the Association, to deposit the proceeds in the Knox National Bank in Mt. Vernon; to "use, manage and conduct the business and affairs of the * * * association, in accordance with his best judgment and discretion * * * *to make payments and disbursements from moneys on hand or received* * * * to liquidate said corporation by collecting upon its assets, and by payment of its true debts and obligations, including the judgment of

the plaintiff herein * * *." (Italics added.) The Farm Loan Act directs the Association's receiver to deposit all funds with the Treasurer of the United States, subject to the order of the Farm Credit Administration. (12 U. S. C. § 962.)

The situation bristles with incipient jurisdictional controversies.

A careful search has disclosed only one case in which a court has appointed a liquidating receiver for a going national bank. This action (by a district court) was reversed by the Circuit Court of Appeals for the Third Circuit, in *Port Newark Nat'l Bank* v. *Waldron*, 46 F. (2d) 96.[7]

In *Hulse* v. *Argentsinger*, 12 F. (2d) 933, 935, the Court stated:

> "The statute confers upon the Comptroller of the Currency, when satisfied of the insolvency of a banking association, the right to appoint a receiver and * * * administer the assets * * *. This provision, it seems to me, plainly gives the Comptroller entire control of the insolvent bank * * *."

In *Pollard* v. *Bailey*, 20 Wall. 520, 527, this Court held that shareholders' double liability could be enforced only by the statutory receiver of a corporation, where the receiver had power to take such action. In its opinion the Court stated:

> "It [the shareholders' liability] was not only to be apportioned and collected, but the mode of apportionment and the manner of collection were specially provided for. The liability and the remedy were created by the same statute. This being so the remedy provided is exclusive of all others. A general liability created

[7] The Comptroller originally had no authority to take over a bank which had placed itself in voluntary liquidation and retired its circulating notes, such power being expressly given to the courts. In 1876, the Comptroller's authority was extended to such banks, and was held to be concurrent with the power previously invested in the courts alone. *King* v. *Pomeroy*, 121 Fed. 287.

by statute without a remedy may be enforced by an appropriate common-law action. *But where the provision for the liability is coupled with a provision for a special remedy, that remedy, and that alone, must be employed.*" (Italics added.)

The question has frequently arisen under state banking laws as to whether the courts of a state are deprived of jurisdiction to liquidate insolvent banks, by statutes which provide for administrative receiverships. An examination of such cases has failed to disclose a single instance in which the courts have assumed jurisdiction. On the contrary, the courts appear to hold uniformly that legislation of this character establishes a special tribunal for the winding up of state banks, and that the state courts have no jurisdiction except to remedy flagrant neglect or abuse of administrative authority. *In re Union Bank,* 204 N. Y. 313, 97 N. E. 737; *Cosmopolitan Trust Co.* v. *Suffolk Knitting Mills,* 247 Mass. 530, 143 N. E. 138; *Miracle* v. *Dixon,* 121 Okla. 180, 249 Pac. 153; *Green* v. *Smith,* 221 Ala. 484, 129 So. 92; *Abbott* v. *Morris,* 101 W. Va. 127; *Labette County Comm'rs* v. *Peterson,* 118 Kan. 560, 235 Pac. 848; *Cartmell* v. *Commercial Bank and Trust Co.,* 153 Ky. 798, 156 S. W. 1048; *Craughwell* v. *Mousam River Trust Co.,* 113 Maine 531, 95 Atl. 221.

There has been a recent legislative interpretation of the Federal Farm Loan Act which furnishes striking evidence of the intention of Congress to provide for an administrative liquidation, to the exclusion of judicial proceedings for that purpose. By the Farm Credit Act of [June 16] 1933, Congress provided for the establishment of a cooperative system of short-term credit institutions, known as production credit associations. §65 of that Act (12 U. S. C. §1038e) provides that, upon default of any obligation a production credit association

> "May be declared insolvent and placed in the hands of a receiver by the Governor [of the Farm Credit Administration] and *proceedings shall thereupon be had in accordance with the provisions of law relating to the insolvency of national farm loan associations.*" (Italics added.)

As passed by the House, this measure contained a provision conferring jurisdiction upon the Federal courts "in cases for winding up such corporations." This provision was stricken out of the bill upon the recommendation of the Senate Committee on Banking and Currency. In explanation of its recommendation, the Committee's report to the Senate stated: "winding up of such corporations and associations is not a judicial proceeding and therefore conferring jurisdiction on Federal courts in such cases would be inconsistent with section 65." (Senate Report No. 124, 73d Congress, 1st Session.) It is therefore apparent that, in providing for the liquidation of insolvent production credit associations, Congress acted upon the legislative interpretation of §29 of the Federal Farm Loan Act, that is: that the liquidation of a national farm loan association, by receivership, "is not a judicial proceeding."

Two circuit courts of appeal have indicated a similar view respecting the effect of §29 of the Act, in recent decisions relating to the administration of insolvent joint stock land banks.

> *Brusselback* v. *Chicago Joint Stock Land Bank, et al.*, (C. C. A. 7th) 69 F. (2d) 598, 599. "The conclusions reached were that the Federal Farm Loan Act contemplated that in case of the insolvency of the bank all of its estate and property, including its farm mortgages taken pursuant to the Act, should be administered by the receiver constituted as in the Act provided, under the general supervision of the Farm [Loan] Board."
>
> *Partridge* v. *St. Louis Joint Stock Land Bank* (C. C. A. 8th) 76 F. (2d) 237. "The [district] court held that

> the Farm Loan Act was a self-contained and comprehensive act governing, not only the organization, powers, duties, and functions of such banks but that it also fully provided for winding up and liquidation of insolvent farm loan organizations of all kinds, without the necessity of resorting to the courts save in exceptional circumstances."

In the last-quoted case, it is clear that the Court referred to the well-recognized principle that a court of equity may always act to correct the flagrant neglect or abuse of administrative authority. In the present case, there has been no showing of any condition warranting the application of that equitable principle.

In *Federal Land Bank* v. *Priddy* (*supra*), this Court considered the effect of §4 of the Federal Farm Loan Act, which grants to the farm credit corporations capacity "to sue and be sued * * * as fully as natural persons." In holding that these corporations are "subject to the incidents of suit, including attachment and execution", the Court placed considerable emphasis on the fact that, under a different interpretation of the law, judgment creditors would be "*relegated to a receivership, allowed as a matter of grace, as the sole means of collecting their judgments.*" In this connection the Court pointed out:

> "Section 29 provides that 'upon default of any obligation, Federal land banks [and national farm loan associations] * * * may be declared insolvent and placed in the hands of a receiver by the Farm Credit Administration * * *'. Except for §4, subjecting federal land banks to suit, * * * there is no other remedy provided for creditors * * * whose judgments are unpaid, and *the receivership is available only through the favorable action of the Farm Credit Administration.*" (Italics added.)

Thus it is apparent that both this Court and the Senate of the United States have indicated the view that the Farm

Loan Act prescribes the exclusive method by which national farm loan associations may be wound up—an administrative receivership, instituted at the discretion of the Farm Credit Administration and conducted under its direction and control. We earnestly submit that the courts below overstepped their jurisdictional limitations, in appointing a receiver to liquidate the Knox Association. Their action, if not reversed by this Court, would directly interfere with the functions of the Association as a Federal instrumentality—would result in dissolution of the Association, which, under the Act, may be accomplished only by Act of Congress or under the provisions of the Federal Farm Loan Act (12 U. S. C. §676, made applicable to national farm loan associations by 12 U. S. C. §716).

The courts below have assumed a prerogative of the Farm Credit Administration. Their action is a direct and immediate interference with the Farm Credit Administration, in the performance of its statutory obligation to supervise and regulate national farm loan associations, either solvent or insolvent. In a later section of this brief, we shall develop the proposition that the Farm Credit Administration has full authority under the law to apply appropriate regulatory measures, other than receivership, to associations which have met with financial difficulties and which, though presently unable to meet their debts without some impairment of capital, are expected to work out within a reasonable period of time. Even if that proposition were erroneous in whole or in part, and though the Farm Credit Administration might have exceeded its discretionary authority, such administrative error could not enlarge the jurisdiction of the court, or endow the State court with power to dissolve a Federal instrumentality.

The same provisions of law control the liquidation of land banks and national farm loan associations. Under the theory applied to this case by the courts below, it lies in the

power of any State court of general jurisdiction to suspend the activities of a Federal land bank, and to destroy that powerful instrumentality of the United States by means of a liquidating receivership. We earnestly submit that the theory of the court below is untenable, and that the judgment is an intolerable interference with the regulatory authority of the Farm Credit Administration—an interference which substitutes the receiver appointed by a State court for procedure adopted by the Farm Credit Administration as appropriate to the exigencies of this and similar cases.

6. The Farm Credit Administration has discretionary authority to appoint or not to appoint a receiver for an insolvent national farm loan association; and to permit an association to continue business operations, notwithstanding an impairment of its capital stock which appears to be temporary, provided the rights of stockholders and creditors are adequately protected.

This Court has determined that the National Banking Act confers discretionary authority upon the Comptroller, and does not require the suspension of business and the appointment of a liquidating receiver in all cases of insolvency. In *Easton* v. *Iowa* (*supra*), the Court reaffirmed the doctrine that a State cannot override the express provisions or the underlying policy of a Federal statute, and pointed out that it was the policy of the National Banking Act to permit the continuance of business by banks which were temporarily embarrassed, in cases where the Comptroller of the Currency deemed it advisable, and to vest the Comptroller with discretionary authority to wind up insolvent banks through receivership. On this point the court stated:

> *"There may be good reason to believe that, though temporarily embarrassed, the bank's affairs may take*

a fortunate turn. Some of the assets that cannot at once be converted into money may be of a character to justify the expectation that, if actual and open insolvency be avoided, they may be ultimately collectible, and thus the ruin of the bank and its creditors be prevented. McDonald v. *Chemical Nat. Bank,* 174 U. S. 610. But, under the state statute, no such conservative action can be followed by the officers of the bank except at the risk of the penalties of fine and imprisonment. *In such a case the provisions of the Federal statute would permit the Comptroller to withhold closing the bank, and to give an opportunity to escape final insolvency. It would seem that such an exercise of discretion on the part of the Comptroller would, in many cases, be better for all concerned than the unyielding course of action prescribed by the state law.* However, it is not our province to vindicate the policy of the Federal statute, but to declare that it cannot be overridden by the policy of the state." (Italics added.)

State courts have affirmed this same policy, upon construction of state banking laws. For example, *Valley Bank* v. *Malcolm,* 23 Ariz. 395, 204 Pac. 207 holds that the state's attorney general is not required to institute receivership proceedings immediately upon receipt of a report of insolvency from the bank comptroller, notwithstanding a statutory provision that it should be "the duty of the Attorney General, upon receiving such notification, to immediately commence suit in the proper court * * * ." In so construing the statute the court stated:

"The failure of a bank and the permanent closing of its activities and the winding up of its affairs through a receiver may in many instances be a public calamity, and the avoiding of such a result is not to be prevented unless the Legislature by the most unmistakable language has so enacted. If in the Attorney General's judgment the interest of the creditors of the bank and those interested in it might be best subserved by a reorganization * * *, there is nothing in the stat-

ute that prohibits such action, and nothing so mandatory in the direction given by the statute as to compel the Attorney General at all events to immediately commence an action which would result in the appointment of a receiver and the closing of the affairs of the bank in that manner."

Similar construction was placed on a Kansas statute providing that it shall be the duty of the bank commissioner to take charge of a state bank immediately upon insolvency, and to appoint a receiver forthwith. In *State* v. *Wilson*, 108 Kan. 641, 196 Pac. 758, the court approved the action of the bank commissioner in withholding receivership, stating:

> "Instead of at once closing the bank, however, the defendant [commissioner] merely exercised a careful supervision over it and within a short time sufficient funds were procured to put it upon a sound footing."

The policy of the foregoing cases has been applied to building and loan associations with impaired capital, which were insolvent within the peculiar meaning of that term as applied to cooperative membership corporations.

In the case of *Bettle, Com'r.* v. *Republic Sav. & L. Assn.*, 63 N. J. Eq. 578, 53 Atl. 11, 14, the Supreme Court of New Jersey stated that insolvency will not always justify the appointment of a receiver.

> "*If, in the earlier stages of its existence, a building and loan association should, by a loss which does not result from inexcusable mismanagement, have its assets reduced below the aggregate amount paid in by the shareholders, but it nevertheless seems probable that, while the life of its shares may be prolonged, they can be matured, I would not appoint a receiver.*" (Italics added.)

In the leading case of *Sjoberg* v. *Security Sav. & L. Assn.*, 73 Minn. 203, 75 N. W. 1116, 1119, it was held that

although there was no valid statute authorizing the voluntary liquidation of an association by its officers, the public examiner was acting within his powers in permitting such liquidation, since the examiner—

> "is given, by statute, express supervision of the affairs of the association; and, where it is not shown that it is reasonably necessary for a court of equity to take the affairs of the corporation into its own hands to protect the interests of the plaintiffs [dissenting shareholders], it will not appoint a receiver."
>
> "The complaint shows that the plaintiffs are not creditors of the defendant, in the usual meaning of the term, but simply stockholders of the defendant; and it makes no claim that the defendant owes anything except to its stockholders. * * * it is manifest that the defendant is insolvent only in the sense that it is impossible for the corporation to mature its stock according to its contract with its stockholders, and that its assets are not sufficient to pay back to such stockholders the money actually paid on their stock. *Where there are no general creditors or liabilities of the corporation except to its stockholders on account of their stock, such a depreciation of assets does not constitute 'insolvency' in the sense in which the word is used * * * [to justify] winding up a corporation on the ground of insolvency*".

Other cases in which the courts have refused to appoint liquidating receivers for building and loan associations, solely on the ground of insolvency, are: *People* v. *Union Bldg. & L. Assn.*, 127 Calif. 400, 58 Pac. 822; *Barton* v. *Enterprise L. & Bldg. Assn.*, 114 Ind. 226, 16 N. E. 486. See also 23 R. C. L. 25.

In the present case, an examination of this record shows the futility of a receivership for the purpose of affording relief to the Respondent. The Act provides (12 U. S. C. § 964) that upon the appointment of a receiver the stock

held by the Association in the Federal Land Bank of its district—

> "shall be canceled without impairment of its liability and all payments on such stock, with accrued dividends, if any, * * * shall be first applied to all debts of the insolvent farm loan association to the Federal land bank and the balance, if any, shall be paid to the receiver of said farm loan association: *Provided,* That *in estimating said debts contingent liabilities incurred by national farm loan associations * * * on account of default of principal or interest of indorsed mortgages, shall be estimated and included as a debt, * * * and the amount * * * shall be deducted in accordance with the provisions of this section from the amount otherwise due said national farm loan association for said canceled stock.*" (Italics added.)

The foregoing provision is plain and mandatory. When an association is placed in receivership, the Federal land bank must cancel all stock standing on its books in the name of the association. The proceeds of such stock must be applied, to the extent necessary, to satisfy all "debts" owing by the association to the bank. These debts will consist of deficiencies established by judgment, or otherwise, following default in the payment of indorsed loans, together with amounts owing under defaulted mortgages, for which the bank has made demand under 12 U. S. C. § 921.

The "contingent liabilities" of an association for "default of principal or interest of indorsed mortgages," which must be deducted from the proceeds of the association's stock in the bank, will consist of the sum total of all outstanding mortgage loans—unpaid principal and accrued interest—which had been indorsed by the Association.

From the inception of every loan made through an association there is a contingent liability for the full amount of such loan. The Association is required to pledge col-

lateral security with the Bank for 5 per cent of this contingent liability, in the form of capital stock purchased from the Bank. The Act forbids a bank "to receive from any national farm loan association additional mortgages when the principal remaining unpaid upon mortgages already received from such association shall exceed 20 times the amount of its [the Bank's] capital stock owned by such association." (12 U. S. C. § 791.) These provisions of the Act indicate the intention of Congress to require that every national farm loan association shall establish a guaranty fund equal to 5 per cent of its contingent liability as indorser of mortgage loans; that such fund shall be invested in stock of the bank and pledged with the bank; and that the fund shall be currently maintained at the same ratio—5 per cent—of the association's contingent liability for outstanding loans.

The congressional intention in this respect is proved beyond question of doubt upon reference to the debates which preceded the passage of the Act, and the reports of congressional committees which studied the measure. For example, it was stated by Senator Hollis, who had charge of the bill on the floor of the Senate, that—

> "there seems to be a consensus of opinion in running savings banks or mortgage institutions that there should be a guaranty fund of 5% of the obligations of the institution and that ratio has been adopted in this bill"; also—
>
> "it is recognized, all over this country and in Europe that in a land-mortgage system you should have a guaranty fund of 5 per cent. You may call it capital. We do in this instance"; also "in order to have a successful mortgage-bank system, it is necessary to have a guarantee fund to take up the slack of the bad loans. If you just loan money on the mortgages, and then put up the mortgages as security for an issue of farm-loan bonds, some day there will appear a bad mortgage and

you will not have anything to take that out of." (*C. R., 64th Cong., 1st Session, pp.* 6693, 6853.)

The Act requires an association to maintain a "guaranty fund" at the bank equal to 5 per cent of its contingent liability as indorser of outstanding loans. When an association is wound up, its invested guaranty fund must be liquidated, and the bank must retain a sufficient portion of the proceeds to set up a reserve of 5 per cent against the unpaid balances of outstanding loans made through the association. Of course, the bank must also retain a sufficient amount from this liquidated fund to establish an ample reserve against the anticipated loss from loans indorsed by the association, which have already gone to foreclosure. This is plainly imperative under 12 U. S. C. § 964, which requires the bank to retain a sum equal to the association's contingent liabilities.

If the Knox National Farm Loan Association were wound up today, it would receive nothing whatever from the liquidation of its principal asset—capital stock of the Federal land bank. This is apparent from the fact that the association's debts to the bank (including net contingent liabilities for defaults under indorsed loans) total $30,377.89,[*] against which the Bank holds a "guaranty fund" consisting of $24,660, in its own capital stock which was purchased and pledged by the Association. (R. pp. 72, 73.) This guaranty fund is equal to 5 per cent of the Association's gross contingent liability for outstanding loans. It would need to be increased by approximately $5,717.89 to satisfy the Association's liability for established losses under foreclosed loans, together with its liability for estimated losses under distressed loans. Therefore, if a receiver would be appointed to liquidate and wind up the Association, the Bank would be impelled to cancel the Association's stock, and retain the entire proceeds—$24,660.

[*] Total amount of Association's indebtedness to Bank, including net contingent liabilities, is reflected by table in Appendix to this brief—p. 89.

On the other hand, if the Association is not placed in receivership and wound up immediately, it may receive the entire proceeds of its guaranty fund, and may be able to pass on to its members sums aggregating approximately $25,000. An examination of the Association's condition, as reflected by the statement set forth on pages 72 and 73 of the record, shows that contingent liabilities are largely offset by corresponding assets. The major contingent liability (outstanding loans) is balanced by the personal liability of each borrower, and by the security which he has furnished in the form of a mortgage. The distressed items under contingent liabilities are largely offset by the Association's equities in real estate securing loans which have gone to foreclosure. The Association's total contingent liability for these items is $17,818.04, but the estimated loss is only $3,228.61. In the light of experience it is not at all over-sanguine to expect that, in the rising real estate market which prevails today in the vicinity of this Association, the estimated losses may never accrue, and may on the contrary develop into a profit which will erase the Association's fixed liability for established losses.

If this Association were wound up today, it would be obliterated. Nothing would be left for distribution to shareholders. This conclusion is inescapable upon an analysis of the Farm Loan Act, which is designed to—and does—establish a credit system founded upon cooperation by the borrowers, designed from the foundation up to insure the safety of investors from whom loan funds would be obtained through the medium of farm loan bonds.

The Act does not require the immediate liquidation of an association which has become insolvent. The provision which authorizes the appointment of a liquidating receiver is permissive—"the Farm Credit Administration *may*." Discretion, thus placed in the hands of the Administration,

is a two-edged sword. The Administration may cut the knot of insolvency with either blade which it selects: It *may* appoint a receiver; or it *may not* take such action, provided the rights of interested parties are preserved and safeguarded.

Receivership is an equitable remedy, and principles of equity must control an administrative agency, which has authority to liquidate quasi public corporations. In the present case it would be highly inequitable and unjust to the 179 shareholders of the Knox Association if their capital investment should be wiped out through an administrative receivership. There would be no gain to the single shareholder who is demanding such liquidation, since his investment, like all the rest, would go in the discard. The only party to be benefited would be the Association's single creditor, the Federal Land Bank. That creditor is willingly proceeding under a plan (Indemnity Agreement) satisfactory to it and to the Farm Credit Administration, for the gradual liquidation of the Association's liabilities. Therefore, the Administration is pursuing the just and equitable course of restricting the operations of this Association by prohibiting the dissipation of capital assets through payments to shareholders, and permitting the Association to continue in operation without a receivership.

We now come to the question of new business. Respondent complains that he is exposed to personal liability for losses which may result from new loans indorsed by the Association. This contention is unsound on two grounds. First, there is no personal liability imposed upon shareholders for any loans indorsed by the Association after June 16, 1933 (12 U. S. C. § 744a). Second, Respondent's personal liability for future debts was terminated when, by paying off his loan, he ceased to utilize the credit facil-

ities of the Association and did everything in his power to terminate his relationship as a shareholder. In *Apsey* v. *Kimball,* 221 U. S. 514, 523, this Court held that:

> "when the shareholders [of a national bank] made their election to retire at the end of the first twenty-year period of corporate organization, and took the steps required * * * they thereby ceased to be shareholders beyond the original twenty-year term of the life of the corporation, and they could neither share its profits, nor be compelled to bear its burdens."

Respondent further complains that his capital investment in the Association is imperilled by the indorsement of new loans. That contention is unsound. It must be presumed that each loan is made upon the security of farm land which has been appraised in the manner required by the Act; and that every precaution has been taken, as required by law, in the manner which was followed when respondent's own loan was originally made (see Appendix, p. 91 *et seq.*). It is true that the Association has assumed a contingent liability for each new loan. However, this liability is counterbalanced by the personal liability of the new borrower, by the lien of the mortgage upon his land, and by the purchase and pledge of new capital stock.

Experience has shown that the financial condition of a national farm loan association is subject to abrupt fluctuation. The likelihood of such fluctuation is inherent in the character and structure of the Association, and must be anticipated by any person who becomes a member thereof. The foreclosure of a single indorsed mortgage may result in an impairment of the Association's capital. Again, the successful liquidation of acquired real estate may eliminate or greatly reduce an existing deficit. An association does business chiefly with the Federal land bank of its district. With few and minor exceptions, the bank is its only creditor.

Debits and credits against the Association's account with the bank are, in large part, bookkeeping transactions.

An association is not always hopelessly insolvent when its debit balance with the land bank exceeds the assets which are presently available for liquidating the same. In the normal course of events, many associations suffer temporary impairments of their capital. Frequently, investigation indicates that an insolvent association may be expected to work out of its difficulties and restore its capital impairment within a reasonable length of time. The Farm Credit Administration and its predecessor, the Federal Farm Loan Board, have recognized this situation by permitting such associations to continue in active operation.

We earnestly submit that the foregoing policy conforms with the principles announced by this Court in *Easton* v. *Iowa* (*supra*), and that the policy has been properly applied to the Knox Association through withholding a liquidating receivership, and permitting the engagement in new business.

The policy of the Farm Credit Administration is neither novel, nor without legal precedent. As this Court pointed out in *Easton* v. *Iowa* (*supra*), it was incorporated in the National Banking Act, by virtue of the language employed by Congress. Years later, with knowledge of the interpretation placed on it by this Court, Congress adopted the same language in the Federal Farm Loan Act.

In 1928 the Federal Farm Loan Board issued a regulation providing for: (1) The classification of national farm loan associations according to their financial condition; (2) the continued operation of associations whose capital stock becomes impaired as the result of financial difficulties apparently temporary in nature; and (3) the gradual liquidation of hopelessly insolvent associations without resorting to receivership. (Appendix, p. 105.) Thereafter, the Board approved the form of Indemnity Agreement used in this

case. (R. p. 87.) The records of the Farm Credit Administration show that this form of agreement was adopted by banks and associations throughout the system, upon the recommendation of the Board, as a practical means of carrying into effect the policy of the regulation of 1928, and safeguarding the rights of the creditors and shareholders of associations with impaired capital.

This regulation, and the auxiliary procedure provided by the Indemnity Agreement were reported to Congress in the 13th Annual Report of the Federal Farm Loan Board for the year ending December 31, 1929. (For full text of that report, see appendix, page 107 et seq.) The regulation has remained in force and effect throughout the past eight years, and its provisions have been republished by the Federal Farm Loan Board and the Farm Credit Administration in handbooks issued to secretary-treasurers and directors of national farm loan associations, in handbooks containing instructions for national farm loan association examiners, etc. The regulation, unchanged except as to details of phraseology, is contained in the compilation of rules and regulations of the Farm Credit Administration, deposited with the Federal Register, pursuant to the requirements of the Federal Register Act. (44 U. S. C. §§ 301, et seq.) (For full text of regulation as deposited for publication in the Federal Register, see appendix, page 105 et seq.)

This regulation provides, in substance, that a national farm loan association may not pay off the stock of a retiring borrower at a time when it is unable to discharge its obligations to creditors from current assets, or to make adequate provision therefor. The regulation effectively prevents the Association from draining off capital assets by payments to shareholders, at a time when it is unable to satisfy creditors.

The Association's capital is invested in stock of the Federal Land Bank, and is pledged with the Bank as a "guaranty fund." The regulation prohibits the Bank from releasing any portion of this guaranty fund if the Association is believed to be hopelessly insolvent; and authorizes the Bank to retain the entire fund (for the time being, at least), in cases where insolvency appears to be temporary. If the Association makes adequate provision for the liquidation of debts which it cannot meet currently, the Bank may release portions of the guaranty fund by cash settlements for stock retired upon the payment of indorsed loans. Thus, an insolvent association is stripped of power to pay out its capital to shareholders, and the key to the situation is lodged with the association's creditor, operating within the terms of the regulation and under the strict supervision of the Farm Credit Administration. (For exposition of legal principles sustaining the Bank's right to retain the Association's pledged capital in this manner, see topic No. 3 of this Argument page 26 *et seq. supra*—particularly passage commencing on page 37.)

When this Respondent became a member of the Knox Association, the outstanding contracts of the organization extended far into the future. During the years which normally would intervene before his retirement from membership, the Association would admit new members and become liable for new loans. During those years the Association's financial condition would rise and fall with the fortunes of its members. In seasons of good crops and high prices, members would keep up the installment payments on their indorsed mortgages; but in seasons of local crop failure or low prices for the agricultural produce of the community, many of the Association's members would be unable to meet their installment payments, and defaults would pile up on the books of the Bank, followed by demands upon the Association to make good as required by 12 U. S. C. § 921. A

severe drought or flood or wind storm would bring seasonal insolvency upon the Association. Nevertheless, Respondent voluntarily became a member and assumed responsibilities of membership, together with the benefits of obtaining a low interest rate on a long-term loan.

He exercised his statutory option to pay off his loan many years before the final installment would have become due, and by the terms of the statute itself his payment was made "under the rules and regulations of the Farm Credit Administration." (12 U. S. C. § 771, Second.) He cannot now be heard to complain of the conditions imposed upon his withdrawal by such regulations, when he voluntarily brought himself within their provisions.

The position which Respondent has taken in the present suit is wholly inconsistent with his previous conduct. The record shows that 4 years before he filed this suit, the Association entered into an "Indemnity Agreement" with the Bank, providing for a gradual liquidation of obligations growing out of defaults under indorsed mortgages. This agreement expressly authorized the procedure of which Respondent now complains:—the retention of stock proceeds by the Bank, to indemnify it against loss upon the final liquidation of defaulted loans, and the postponement of immediate enforcement of the Association's liability for such loans. (R. pp. 87 *et seq.*—Ex. F.) Respondent did not plead ignorance of this agreement, and of the practice which was followed in pursuance thereof. Respondent did not show or attempt to show that he had ever protested against the arrangement during the four years when he was an active member of the Association.

Respondent was a member of the Association with full voting privilege during the years 1933-1935. He does not show that he made any attempt whatever as a member to curtail the activities of the Association in making new loans.

On the contrary, the record indicates that he sat by and permitted the directors of the Association, without objection on his part, to admit many new members and indorse new loans in excess of $100,000, during this period. Notwithstanding this inaction on his part, he now comes into court and asks for a judicial decree which will terminate the life of the Association, and cause its immediate and complete dissolution. He bases his demand largely upon the fact that the Association has made the new loans to which he did not object.

In permitting an association to accept new business, though its stock is subject to some impairment, the Farm Credit Administration confines this privilege to associations apparently "able to work out of their difficulties within a reasonable time." For the purpose of determining what is a reasonable time, it is necessary to bear in mind the nature of the Association's business. That business is to obtain long-term loans for its members from the Federal Land Bank. No such loan may be written with a final payment date of less than five years. In actual practice, the great majority of loans have been amortized for periods of more than 30 years. As of January 1, 1924, no loans had been written for a term of less than 30 years.[9] As of December 31, 1929, 95.5% (in amount) of all outstanding loans had been made for terms of more than 30 years.[10] During the period of greatest lending activity in the history of the Federal land bank system (May 1, 1933-September 30, 1934), 78.2% (in amount) of loans made were amortized for terms of more than 30 years, and 17.4% for terms of

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[9] Department of Agriculture Bulletin No. 288—"Farm Mortgage Credit", February, 1932—page 77.

[10] Data assembled by Federal Farm Loan Board, and included in letter addressed to Alexander Brown and Sons by the acting Farm Loan Commissioner under date of April 22, 1930.

20 years.[11] In such business, time moves slowly, and "reasonable time" is not a matter of days.

We have already demonstrated that if the Knox National Farm Loan Association should be wound up today, there would be no assets available for distribution to shareholders. Even if this were not true, and if some assets would be available for that purpose, we submit that respondent would not be entitled to demand the dissolution of the Association, or the cessation of new business, merely on the ground of insolvency. As was stated regarding a private corporation in *Sutton Mfg. Co.* v. *Hutchinson* (C. C. A. 7th), 63 F. 496, 501:

> "A corporation is not required by any duty it owes to creditors to suspend operations the moment it becomes financially embarrassed, or because it may be doubtful whether the objects of its creation can be attained by further effort upon its part. *It is in the line of right and of duty when attempting, in good faith, by the exercise of its lawful powers and by the use of all legitimate means, to preserve its active existence, and thereby accomplish the objects for which it was created.*" (Italics added.)

The Association is a quasi-public corporation—an instrumentality of the Government. Congress evidently believed that the interests of the public do not necessarily require the immediate liquidation of an insolvent association. This belief is apparent, both from the permissive language used in authorizing the appointment of a receiver, and from the proviso which prohibits any receivership "until the total amount of defaults of current interest and amortization installments on loans indorsed by national farm loan associations shall amount to at least $150,000 in the Fed-

[11] Second Annual Report of the Farm Credit Administration (1934), page 103, table 10.

eral land bank district, unless such association shall have been in default for a period of two years." (12 U. S. C. §961.)

In a single sentence, Congress gave sweeping authority to wind up an association upon failure "to meet its outstanding obligations of any description" and limited that power by a proviso which, at first glance, appears wholly irrelevant. The purpose of this limitation becomes apparent upon study, and furnishes a significant guide to the interpretation of the statute.

This proviso forbids the stringent remedy of receivership, except when necessary for the protection of the Federal Land Bank—the common creditor of all associations in its district—from the danger of loss through an accumulation of defaults under indorsed mortgages. Unless and until such defaults constitute a substantial item on the books of the Bank, and a resultant threat to the safety of bonds issued against indorsed mortgages, the Farm Credit Administration is without power to wind up a single insolvent association. *The power to liquidate an association is not based primarily upon its individual financial condition, but rather upon the necessity of safeguarding the bank in cases where the defaults of that association and others in the district have imperiled the financial condition of the bank.*

This proviso shows congressional recognition of the fact that receivership would, in most cases, wholly obliterate an association. It shows that Congress expected individual associations to become financially embarrassed, and to continue operations notwithstanding temporary inability to meet their debts. It shows that Congress desired the associations of each district to be given an opportunity to work out of their difficulties, and that individual associations should be wound up only where the Farm Credit Administration deems such action necessary for the welfare of the

district as a whole: The Farm Credit Administration, and its predecessor, the Federal Farm Loan Board, have administered the Act in accordance with this basic principle.

The Knox Association is operating under a regulation which is well adapted to the long-time aspect of a national farm loan association. The regulation enables the Association to continue its business on a restricted basis, and to conserve capital assets during a period of financial distress. Pending the Association's expected rehabilitation, the regulation insures full protection to its only creditor, the Federal Land Bank, together with old and new stockholders. The fundamental principle underlying the regulation is identical with that affirmed in *Easton* v. *Iowa* (*supra*).

We earnestly submit that the Farm Credit Administration has full and ample authority to enforce the regulation in question, as an appropriate and reasonable means of accomplishing the result for which a liquidating receivership is authorized, and that the courts below had no power to interfere with the application of the regulation to the petitioner Association.

Conclusion.

Respondent voluntarily became a member of the Federal Land Bank System, by joining its local unit, the Knox National Farm Loan Association. For years, Respondent enjoyed the benefits of membership—long-term credit at low interest. Respondent may not now evade the responsibilities which he undertook in joining the system, either by withdrawing his capital from the Association during its present financial difficulty, or by procuring a dissolution of the Association, merely because his own artive participation is at an end.

Congress, in the exercise of its constitutional powers, established the Federal Land Bank System. Congress has

exclusive power to provide for the regulation of the institutions comprising the system. Congress has dealt directly with the subject of the insolvency of these institutions, and has made full and adequate provision for the protection of creditors of the system. It is not competent for a state court to interfere with the system by appointing a receiver for its unit, the Knox National Farm Loan Association, and thereby obstructing the exercise of the powers bestowed upon the system by the general government.

We respectfully submit that, for the reasons stated in this brief, the decision of the court below should be reversed.

Respectfully submitted,

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	Debits with no contingent liabilities.	Debits and gross contingent liabilities.
...ciation to Bank.		
...ment by the Bank on liabili... ...ing two loans ...ciation, with inter... ...date of the trial	$2,489.28	$2,489.28
...ciation will ...ns of (c) and (d) ...for stock proceeds with... ...by the Bank ($325.00)	3,228.61	
	($5,717.89)	
...) contingent liability.— ...(principal and interest ...foreclosure costs, etc.) in three ...of real estate, which had se... ...secured by the Associa...		$11,074.33
...contingent liability.— ...principal and accrued interest of ...loans in foreclosure		6,743.71
...contingent liability.— ...amount of outstanding ...by Association (the un... ...loans was not as... ...total, but it is fair to ...the total has not been sub... ...by payments on		493,200.00
...liability.— ...by Association by Association (c) indorsed	$24,000.00	
.....	*$30,577.89	$513,507.32

...Indebtedness to Bank, including net ...from sales of stock

APPENDIX

TABLE

Chronological Statement of Facts.	Applicable Provisions of Federal Farm Loan Act (References to United States Code).
November 5, 1924.	12 U. S. C. § 733.
Application was made through the Association, in writing, for a Federal land bank loan of $5,300. The applicants (Roberts et al.) offered as security a first mortgage on farm land located in Knox County, Ohio. The applicants subscribed "for the amount of capital stock in said association that this loan will involve under the terms of the Federal Farm Loan Act"; and in stating the objects to which the proceeds of the loan would be applied, the applicants included payment for said stock in the Association. (R. pp. 77-84.)	"Any person desiring to borrow on farm land mortgage through a national farm loan association * * * shall subscribe for shares of stock in such farm loan association to an amount equal to 5 per centum of the face of the desired loan, said subscription to be paid in cash upon the granting of the loan."
	12 U. S. C. § 771, Eighth.
	"Every applicant * * * shall make application on a form to be prescribed for that purpose by the Farm Credit Administration, and * * * shall state the objects to which the proceeds of said loan are to be applied."

Chronological Statement of Facts—Continued.

November 5, 1924.

The investigator for the Association's loan committee investigated the property, its earning power under normal conditions, and the solvency, character and qualifications of the applicants. The investigator reported, in writing, recommending a loan for an amount not to exceed $7,950. (R. p. 85.)

Applicable Provisions of Federal Farm Loan Act (References to United States Code)—Continued.

12 U. S. C. § 742.

"Any person desiring to secure a loan through a national farm loan association * * * may * * * borrow from the Federal land bank through such association the sum necessary to pay for shares of stock subscribed for by him in the national farm loan association, such sum to be made a part of the face of the loan and paid off in amortization payments."

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12 U. S. C. § 751.

"Whenever an application for a mortgage loan is made through a national farm loan association, the loan committee * * * shall forthwith make, or cause to be made, such investigation as it may deem necessary as to the character and solvency of the applicant, and the sufficiency of the security offered, and cause written report to be made of the result of such investigation."

November 8, 1924.

The loan committee unanimously approved, in writing, the report and recommendation of its investigator. (R. p. 85.)

12 U. S. C. § 751.

The loan committee "shall, if it concurs in such report [of the investigation which it has caused to be made], approve the same in writing. No loan shall be made unless the report is favorable, and the loan committee is unanimous in its approval thereof."

November 29, 1924.

The Association's board of directors considered the application, and recommended to the Bank that a loan be granted to the applicants in an amount not exceeding $7,950, on the land tendered as security; and by a vote of two-thirds or more, the board of directors admitted the applicants to membership in the Association. (R. p. 85.)

12 U. S. C. § 745.

"any person who is the owner * * * of farm land qualified * * * as the basis of a mortgage loan, and who desires to borrow on a mortgage of such farm land, may become a member of the association by a two-thirds vote of the directors upon subscribing for one share of the capital stock of such association for each $100 of the face of his proposed loan * * *."

Chronological Statement of Facts—Continued.

November 29, 1924.

The application, together with the written report of the Association's loan committee and a record of the action taken by its board of directors thereon, were submitted to the Bank by the Association. (R. pp. 9, 43.)

December 4, 1924.

The application and the report of the Association's loan committee were referred to a land bank appraiser. (R. pp. 9, 86.)

January 6, 1925.

The land bank appraiser made a written report of his investigation of the land offered as security,

Applicable Provisions of Federal Farm Loan Act (References to United States Code)—Continued.

12 U. S. C. § 752.

"The written report [of the Association's loan committee] * * * shall be submitted to the Federal land bank, together with the application for the loan, and the directors of said land bank shall examine said written report when they pass on the loan application which it accompanies, but they shall not be bound by said appraisal."

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12 U. S. C. § 753.

"Before any mortgage loan is made by any Federal land bank, * * * it shall refer the application and written report of the loan committee to one or more of the land bank appraisers appointed under the authority of [12 U. S. C.] section 656."

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12 U. S. C. § 753.

"* * * such appraiser * * * shall investigate and make a written report upon the land

and recommended favorably upon the application for a loan. (R. pp. 9, 86.)

January 10, 1925.

The Bank, by its executive committee, approved the application for a loan of $5,300, subject to requirements as to insurance upon the property. (R. p. 86.)

May, 1925

The borrowers (Roberts et al.) executed and delivered to the Federal Land Bank of Louisville their promissory note for the principal sum of $5,300, with interest at the rate of 5½ per cent per annum, payable in accordance with amortization tables promulgated by the Federal Farm Loan Board, in 68 semi-annual installments of $171.25, on the first of January and July of each year to and including 1959, and a final payment of $171.77, payable on the first day of January, 1960. The note reserved to borrowers the privilege of making additional payments for the reduction or satisfaction of principal, on any installment date after five years from the date of said note.

offered as security for said loan. No such loan shall be made by said land bank unless said written report is favorable."

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12 U. S. C. § 771, Ninth.

"Every borrower shall undertake to keep insured * * * all buildings the value of which was a factor in determining the amount of the loan."

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12 U. S. C. § 771, First.

Loans made by a Federal land bank "shall be secured by duly recorded first mortgages on farm land."

12 U. S. C. § 771, Second.

"Every such mortgage shall contain an agreement providing for the repayment of the loan on an amortization plan by means of a fixed number of annual or semiannual installments sufficient to cover * * * interest * * * and * * * such amounts to be applied on the principal as will extinguish the debt within an agreed period, not less than five years nor more than forty years:

Chronological Statement of Facts—Continued.

At the same time, the applicants executed and delivered to the Bank a first mortgage upon their farm land, which was duly recorded. (R. pp. 9, 29, 32.)

May, 1925.

The Association indorsed and became liable for said note, before delivery to the bank. (R. pp. 11, 32A.)

Applicable Provisions of Federal Farm Loan Act (References to United States Code)—Continued.

Provided, That after five years from the date upon which a loan is made the mortgagor may, upon any regular installment date, make in advance any number of payments or any portion thereof on account of the principal of his loan * * * or pay the entire principal of such loan, under the rules and regulations of the Farm Credit Administration."

12 U. S. C. § 662.

The Farm Credit Administration (formerly Federal Farm Loan Board) "shall prepare and publish amortization tables which shall be used by national farm loan associations and land banks."

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12 U. S. C. § 761.

"Every national farm loan association shall have power * * * to indorse, and thereby become liable for the payment of, mortgages taken from its shareholders by the Federal land bank of its district."

May, 1925.

At the time of the execution and delivery of the promissory note and mortgage and the closing of the loan evidenced and secured thereby, the following transactions occurred:

The borrowers paid for 53 shares of capital stock in the Association (at $5.00 per share) for which they had subscribed in their loan application;

Said stock was held by the Association (which had indorsed and become liable for the mortgage) as collateral security for the payment of the loan; and

The Association, in turn, paid for 53 shares of capital stock, in the Bank (at $5.00 per share), and the Bank held said stock as collateral security for the payment of the indorsed loan. (R. pp. 11, 12, 53, 74.)

12 U. S. C. § 733.

The applicant's stock subscription shall "be paid in cash upon the granting of the loan. * * *

"Said capital stock shall be held by said association as collateral security for the payment of said loan, but said borrower shall be paid any dividends accruing and payable on said capital stock while it is outstanding."

12 U. S. C. § 721.

"Whenever any national farm loan association shall desire to secure for any member a loan on first mortgage from the Federal land bank of its district it shall subscribe for capital stock of said land bank to the amount of 5 per centum of such loan, such subscription to be paid in cash upon the granting of the loan by said land bank. Such capital stock shall be held by said land bank as collateral security for the payment of said loan,

Chronological Statement of Facts—Continued.

May, 1925.

The Bank transmitted the net proceeds of said loan to the Association, after deducting authorized fees and charges; and the Association then paid over said net proceeds, less its authorized fees and charges, to and/or for the account of the borrowers, Roberts et al. Before transmitting the loan proceeds to the Association, the Bank deducted the par value of the shares of stock which were purchased and pledged by the Association in connection with said loan; and the Association, in turn, issued its stock to the borrowers. (R. pp. 11, 12.)

Applicable Provisions of Federal Farm Loan Act (References to United States Code)—Continued.

but said association shall be paid any dividends accruing and payable on said capital stock while it is outstanding."

12 U. S. C. § 693.

"Stock [of a Federal land bank] held by national farm loan associations shall not be transferred or hypothecated, and the certificates therefor shall so state."

12 U. S. C. § 761.

"Every national farm loan association shall have power * * *. To receive from the Federal land bank of its district funds advanced by said land bank, and to deliver said funds to its shareholders on receipt of [qualified] first mortgages * * *. To fix reasonable initial charges to be made against applicants for loans and to borrowers in order to meet the necessary expenses of the association * * *."

October, 1927.

Respondent purchased the Knox County farm from the original borrowers (Roberts et al.), and assumed and agreed to pay the mortgage held by the Bank. At the same time, and as a part of the same transaction, Respondent purchased from his vendors their shares of stock in the Association. By a written instrument dated October 10, addressed to the Bank, Respondent expressly "*assumed all the liabilities of membership*" incident to the purchase of said stock and the assumption of said loan. Respondent was duly elected to membership in the Association, and the Association's action was certified to the Bank by its secretary-treasurer on October 24. The Bank acquiesced in the entire transaction. (R. p. 39.)

12 U. S. C. § 771, Sixth.

"In case of the sale of the mortgaged land, the Federal land bank may permit said mortgage and the stock interests of the vendor to be assumed by the purchaser."

12 U. S. C. § 744.

"Shareholders of every national farm loan association shall be held individually responsible, equally and ratably, and not one for another, for all contracts, debts and engagements of such association to the extent of the amount of stock owned by them at the par value thereof, in addition to the amount paid in and represented by their shares."

12 U. S. C. § 744a.

"* * * shareholders * * * shall not be held individually responsible for any contract, debt, or engagement of such association entered into after June 16, 1933, but this section shall not be construed to relieve any other liability with respect to stock held by such shareholders."

Chronological Statement of Facts—Continued.

October 24, 1927.

The Association executed and delivered to Respondent a written instrument designated "receipt for stock held by Knox National Farm Loan Association." This instrument recited that a certificate for 53 shares of the Association's stock had that day been issued to Respondent, and that the stock was being held by the Association "pursuant to the provision of the Federal Farm Loan Act as collateral security for the payment of the loan"; also, that it "represents your investment in stock on which dividends will be paid. It will be accepted at face value on final payment of the loan." (R. p. 71.)

November, 1928.

The Federal Farm Loan Board adopted a regulation, providing for the classification of national farm loan associations with respect to their financial condition, and prescribing the procedure which should be followed, upon the repayment of

Applicable Provisions of Federal Farm Loan Act (References to United States Code)—Continued.

12 U. S. C. § 733.

"Said capital stock shall be paid off at par and retired upon full payment of said loan. Said capital stock shall be held by said association as collateral security for the payment of said loan, but said borrower shall be paid any dividends accruing and payable on said capital stock while it is outstanding."

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12 U. S. C. § 831.

"The Farm Credit Administration [formerly Federal Farm Loan Board] shall have power—

"(i) To exercise general supervisory authority over the Federal land banks, the national farm

loans, in connection with the retirement of the capital stock of the Federal land banks, and the associations of different classifications. (Appendix to this brief, page 105.)

The regulation of the Federal Farm Loan Board respecting stock retirement has been continued in force and effect by the Farm Credit Administration.

March, 1931.

The Association and the Bank agreed upon a method for liquidating obligations incurred by the Association as indorser of mortgage loans. The agreement provided, in substance, that where the Bank should acquire the real estate which had secured an indorsed loan, such property should be administered and sold for the mutual benefit of the Bank and the Association, and that the

Chronological Statement of Facts—Continued.

ciation's liability as indorser should not be determined by the price bid at foreclosure sale, but by the net loss, if any, sustained upon the final disposition of the property; also, that the Association should be credited with any net profits realized from the sale of such acquired property, to the extent necessary to balance the Association's account with the Bank. It was further provided that: "For the purpose of securing the performance of this agreement, all or any portion of dividends which may be declared upon the Bank's stock recorded in the name of the Association, * * * and any sums, including the proceeds of retired stock, which might otherwise be payable by the Bank to the Association, may to the extent deemed necessary by the Bank, be retained by it as a Real Estate Indemnity Account, against which account shall be charged the actual losses, if any, sustained by the Bank on account of the operation, maintenance or disposition * * * of any such lands, * * * when such losses are ascertained * * *." (R. p. 87.)

Applicable Provisions of Federal Farm Loan Act (References to United States Code)—Continued.

amount unpaid thereon in cash or by the substitution of an equal amount of Federal farm loan bonds, with all unmatured coupons attached."

March, 1933.

The unpaid balance of the loan involved in this suit had been reduced to $2,122.46 (principal and accrued interest). Respondent made the following tender, as in full satisfaction of said sum: $1,857.46 in cash, together with his receipt for Association stock (par value of $265). The Bank rejected said tender and returned the check and stock receipt to the Association.

At the date of said tender and at all times since, the Association has been in "Class 2"—that is, its capital stock has been impaired, due to its inability to meet, from current assets, its obligations to the Bank as indorser of defaulted mortgage loans, although it is believed that such impairment

12 U. S. C. § 771, Second.

"Every * * * mortgage [accepted by a Federal land bank] shall contain an agreement providing for the repayment of the loan on an amortization plan by means of a fixed number of annual or semiannual installments sufficient to cover * * * interest * * * and * * * such amounts to be applied on the principal as will extinguish the debt within an agreed period, not less than five years nor more than forty years: *Provided,* That after five years from the date upon which a loan is made, the mortgagor may * * * make in advance any number of payments or any portion thereof on account of the principal of his loan as provided by his contract or pay the entire principal of such loan, under the rules and regulations of the Farm Credit Administration."

Regulation of Farm Credit Administration, Respecting the Retirement of the Capital Stock of Federal Land Banks and National Farm Loan Associations

(Appendix, pages 91-117, *et seq.*)

Chronological Statement of Facts—Continued.

is temporary. The Association has, therefore, been unable to pay off the stock of retiring members.

April, 1933.

Respondent paid to the Bank, through the Association, the sum of $1,857.46, which the Bank applied to the mortgage loan, leaving an unpaid balance of approximately $265. (R. pp. 12, 47.)

August, 1934.

Respondent brought this suit against the Bank and the Association in the Court of Common Pleas of Knox County, Ohio, following repeated demands upon the Bank and the Association, that Respondent's receipt for Association stock be accepted in full satisfaction of the unpaid balance of said loan. (R. p. 4.)

APPENDIX.

Excerpt from "Federal Register Compilation" of Rules and Regulations of Farm Credit Administration, Respecting Federal Land Bank System.

RETIREMENT OF THE CAPITAL STOCK OF FEDERAL LAND BANKS AND NATIONAL FARM LOAN ASSOCIATIONS

SECTION 19.—*Retirement in the case of repayment of loans (effective November,* 1928; *as amended May* 13, 1935, *December* 16, 1935).*

(a) Each Federal land bank shall establish a practical procedure for carrying out the provisions of the Federal Farm Loan Act, as amended, with respect to the retirement of the capital stock of the Federal land banks and national farm loan associations in the case of repayment of loans. In making a specific application of the general legal principles of stock retirement to the problems presented by the individual associations in its district, each bank should classify such associations with respect to their financial condition, on the following general basis: (1) Associations able to meet their obligations currently and free from distressed loans are to be placed in class 1; (2) associations apparently unable to meet their obligations currently without a present impairment of their capital, but, in the opinion of the bank, able to work out of their difficulties within a reasonable time, are to be placed in class 2; (3) associations unable to meet their obligations currently without a material impairment of their capital, although to an extent not

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[12] Various aspects of this subject are developed in more detail in an opinion [by Peyton R. Evans] entitled "Retirement of Stock of National Farm Loan Associations and Federal Land Banks in Case of Repayment of Loans' (Treasury Department, Federal Farm Loan Bureau, 1928), officially adopted by the Federal Farm Loan Board as a regulation, and on pages 27 to 33 inclusive of "A Handbook for Officers and Directors of National Farm Loan Association" (Government Printing Office, 1935) issued by the Farm Credit Administration. The contents of that opinion and the pages of the hand-book referred to are incorporated herein and made a part hereof, and are available for inspection at the Farm Credit Administration at Washington, D. C.

exceeding the aggregate amount thereof, and, in the opinion of the bank, unable to work out of their difficulties within a reasonable time, are to be placed in class 3; (4) associations whose unsatisfied obligations equal or exceed the amount of their capital are to be placed in class 4.

(b) When a borrower pays his mortgage debt in full and the national farm loan association through which the loan was made is in class 1, the bank shall pay off at par and retire the stock standing on its books in the name of the association, which was subscribed for by it at the time the loan was made, and shall pay the par value of such stock to the association. In that event, the association shall pay to the retiring borrower the par value of said stock less any personal indebtedness of such borrower to the association; provided, however, that the bank may, upon the order and with the consent of the association, credit the par value of such stock upon the retiring borrower's mortgage.

(c) Where the association is in class 2, the bank after retiring its stock may, in its discretion, pay to the association all or a portion of the proceeds of such retired stock. If the bank pays to the association in cash a portion of the proceeds of its retired stock, the association may pay the retiring stockholder a similar amount, less any personal indebtedness of the borrower to the association, in full settlement of the value of his stock. If, however, the bank elects to retain all the proceeds of its retired stock, the association, unless it has other funds available may not make a payment to the retiring borrower until it has paid, or has made adequate provision for paying, its indebtedness to its creditors and has sufficient funds available for distribution among its former shareholders on a pro rata basis. In such cases the association may issue to each retiring borrower a certificate which would recite, in effect "that the holder of this certificate is entitled to share pro rata on the basis of — shares of capital stock of the aggregate par value of $——, of the —— National Farm Loan Association of ——, in the distribution of the net proceeds of all its capital stock after all of its indebtedness has been satisfied.

(d) Where the association is in class 3 or 4, the bank shall retain the full amount of the proceeds of such retired stock and apply the same as a credit on the debts due by such association to the bank. In such cases, the association may issue to each retiring borrower a certificate in the form indicated in the preceding paragraph.

(e) An association in class 1 may, unless disqualified for some other reason, accept applications for loans. When an application for a loan is presented to an association in class 2, the secretary-treasurer shall advise the applicant, before the application is accepted, that the par value of the stock which he will be required to take may be, or may become, impaired through losses on account of defaults in other loans, and that it may not be possible for the association to repay the par value of the stock when the loan is paid off. Associations in classes 3 and 4 shall not be permitted to accept applications for loans.

APPENDIX.

Excerpt From 13th Annual Report of the Federal Farm Loan Board, for the Year Ending December 31, 1929.

RETIREMENT OF STOCK OF FEDERAL LAND BANKS AND NATIONAL FARM LOAN ASSOCIATIONS.

During the past two years there has been an important clarification of policy and procedure in connection with the determination of the conditions under which the capital stock of Federal land banks and national farm loan associations should be retired in accordance with the provisions of the farm loan act. Under the law, stock of a Federal land bank owned by associations may, in the discretion of the bank's directors and with the approval of the Farm Loan Board, be paid off at par and retired, and it must be so paid off and retired upon full payment of the mortgage loan. In such case—i.e., upon full payment of the loan—the national farm loan associations must pay off at par and retire the corresponding shares of its stock which were issued

when land bank stock was issued. Certain other requirements and objectives of the law made it necessary, however, to define carefully the conditions under which such stock may be retired and to work out a uniform and equitable procedure that would carry out the theory and purpose of the act and respect the rights and obligations of all concerned.

Stock of the Federal land banks is owned by the national farm loan associations; the stock of national farm loan associations is owned by the borrowers. Each association indorses and thereby becomes liable for the payment of all qualified first mortgages securing loans made by the Federal land bank to its members. By such indorsement the association becomes primarily liable with the borrower for the payment of the whole mortgage debt. The Supreme Court of the State of Washington has held that when a loan is made to a borrower through an association the association becomes a joint borrower with the applicant.

Section 25 of the law sets forth specifically the extent of the association's liability on its indorsement for defaults occurring in connection with loans made to its members. That section reads:

If there shall be default under the terms of any indorsed first mortgage held by a Federal land bank under the provisions of this title, the national farm loan association through which said mortgage was received by said Federal land bank shall be notified of such said default. Such association may thereupon be required, within 30 days after such notice, to make good such default, either by payment of the amount unpaid thereon in cash or by the substitution of an equal amount of Federal farm loan bonds, with all unmatured coupons attached.

Under this provision, the bank may give notice to the association that there has been a default in the payment of any indorsed first mortgage and within 30 days from the date thereof may require the association to make good such default. In other words, the bank may require the association to pay the note before exhausting its rights under the mortgage.

The responsibility of the shareholders for the payment of these obligations is provided for in section 9 of the Act:

Shareholders of every national farm loan association shall be held individually responsible, equally and ratably, and not one for another, for all contracts, debts, and engagements of such association to the extent of the amount of stock owned by them at the par value thereof, in addition to the amount paid in and represented by their shares.

In other words, shareholders of a national farm loan association are equally and ratably responsible, to the extent stated, for all contracts, debts, and engagements of the association "in addition to the amount paid in and represented by their shares." Therefore, the assets represented by the stock must be held liable for all contracts, debts, and engagements of the associations. This provision of the law is incorporated in extenso in the by-laws of every national farm loan association, and by this action each association has recognized that the stock held by its members is liable for the debts incurred by it in the course of its business operations.

Section 29 of the act provides that, upon receiving satisfactory evidence that any national farm loan association has failed to meet its outstanding obligations of any description, the farm loan board, under the conditions stated in the act, may forthwith declare such association insolvent and appoint a receiver. That section also states that, when an association is declared insolvent under its provisions, the land bank must cancel the stock of the bank owned by the association and apply the proceeds to all debts of the insolvent association. In this connection, the courts have repeatedly held, in cases of building and loan associations, that if an association has failed to meet its outstanding obligations of any description, or is in such a condition that it is impossible for it to meet such obligations or to pay back to stockholders the amount of their contributions dollar for dollar, a retiring borrower is not entitled to the face value of his stock or to have the face amount applied as a credit on his mortgage debt. This is the rule adopted by the Federal courts. These well established principles

of the general law apply with equal force to cases where national farm loan associations have failed to meet their obligations. In such cases, a retiring member-borrower is not entitled to the face value of his stock in his association.

As previously pointed out, the act provides that, upon full payment of a mortgage loan, the bank must pay off at par and retire the stock standing on its books in the name of the association which was pledged with the bank as collateral security for the payment of said loan. It must be borne in mind that this transaction is with the association, not the borrower. This provision makes the bank liable to the association for the par value of the stock. If at the same time the association, as indorser of a defaulted loan, has failed to make good such default in accordance with the provisions of section 25 hereinbefore referred to, and is indebted to the bank, the mutual demands of the bank and the association, under universally established principles of law, may be set off one against the other. This right is not dependent upon any formal determination of insolvency of the association, but is a right incident to the relationship of creditor and debtor arising under the association's indorsement of the loans made to its members. Where, therefore, a borrower seeks to pay off his loan through an association that is unable to meet its obligations as indorser, the bank, while retiring its stock owned by the association, must of necessity withhold the payment to the association of all or a portion of the proceeds of such stock and offset such proceeds against the association's indebtedness to it. In such circumstances the association in turn retires the stock standing on its books in the name of the borrower, but the borrower-stockholder is entitled only to his pro rata share of the value of the capital assets of the association after provision has been made for the satisfaction of its obligations. If the bank pays to the association in cash a portion of the proceeds of its stock, the association in turn may pay the borrower-stockholder a similar amount in full settlement of the value of his stock, unless he is personally indebted to the association, in which event the amount involved would be offset against such indebtedness. If, however, the bank finds it necessary to retain all the proceeds of its retired

stock on account of the association's indebtedness to it, the association, unless it has other funds available, is not in a position to pay its borrower-stockholder, but in such case he is entitled to share pro rata in the distribution of the net proceeds, if any, of the association's capital assets after its indebtedness has been satisfied.

On the other hand, if an association has met all its obligations currently, including its obligations as indorser, at the time one of its members pays off his loan in full, he is entitled to receive the par value of his stock provided he is not personally indebted to the association, in which case all or so much of the proceeds of such stock as may be necessary are offset against his indebtedness.

Clearly any statement made in forms of stock receipts or otherwise, to the effect that the shares are to be paid off and retired at par upon the repayment of loans presupposes the solvency of the association issuing such shares and its continued ability to meet its obligations currently. This is true, for example, with respect to certificates of deposit issued by commercial banks which purport to be absolutely payable under certain specified conditions with interest at an agreed rate. These certificates are issued in good faith, but their redemption, as everyone is presumed to know, is subject to the necessarily implied condition that should the bank suspend operations before the money is withdrawn the depositor will be entitled to payment thereof only if and to the extent that the assets of the bank are sufficient for the purpose.

In the consideration of this subject, the significance of the requirement in section 7 that "the capital stock of a Federal land bank shall not be reduced to an amount less than 5 per cent of the principal of the outstanding farm loan bonds issued by it," should not be overlooked. The reasons prompting the Congress to insert this provision in the act may be explained by reference to the report of the joint committee of the Senate and House, recommending to the Sixty-fourth Congress a bill providing for an agricultural credit system adapted to the needs of the American farmer. In this report the general plan of the present

farm loan system was outlined and it contained the following remarks:

Every farm loan bond is secured as follows:

1. By the capital, reserves, and earnings of the land bank which issues it.

2. By the capital, reserves, and earnings of the 11 other land banks.

3. By the collective security of all the mortgages in its division (limited or unlimited) of the land bank, the mortgages pledged being at least equal in amount to the outstanding bonds.

Every mortgage pledged as collateral is secured as follows:

1. By the personal undertaking of the borrower.

2. By the security of the mortgaged land, at least double in value to the amount of the loan.

3. By the capital, reserves, and earnings of the local association, indorsing the loan.

4. By the individual liability of the members of the indorsing association.

While farm loan bonds issued by a Federal land bank are primarily secured by mortgages or Government obligations, the foregoing statement of the committee clearly shows that the Congress intended that the capital, reserves, and earnings of Federal land banks and national farm loan associations would constitute additional protection for such bonds. In addition to the statements made by the committee, repeated references were made, during the course of the debates in the Senate and House at the time the act was being considered by the Congress, to the fact that the 5 per cent margin of stock provided for in the act was intended as a guarantee fund to absorb losses which would inevitably occur. These references to the debates in Congress indicate that the proponents of the act understood that the bondholders as creditors were to be given primary consideration,

and that their claim to the capital and surplus of national farm loan associations was superior to that of the retiring stockholder.

Section 21 of the act provides, in part, that every farm loan bond issued by a Federal land bank shall contain in the face thereof a certificate signed by the farm loan commissioner, to the effect that it is issued under the authority of the Federal farm loan act, has the approval in form and issue of the Federal Farm Loan Board, and is legal and regular in all respects; that it is issued against collateral security of United States Government bonds, *or indorsed first mortgages on farm lands*, at least equal in amount to the bonds issued; and that all Federal land banks are liable for the payment of each bond. It is evident from this provision that the Congress considered that the indorsement of mortgages by national farm loan associations was an important part of the security behind all bonds issued by Federal land banks.

In the light of the decisions of the courts, the statements which appeared in the report of the joint committee of the Senate and House of Representatives regarding the bill which it had prepared, and the provisions of the act which the Congress passed with this information before it, it is apparent that the right of a retiring borrower in the farm loan system to share in the distribution of its stock assets exists only after the debts of the association have been paid, and that he can not be paid in cash the par value of his shares at the time of the retirement of his loan if the association of which he is a member is unable to meet its outstanding obligations currently.

In the past, the important questions herein discussed have created much confusion and doubt in the Federal land bank system. The construction of the act, based upon an exhaustive study of the subject, has made the rights and obligations of the banks, the associations, and the borrowers clear and definite. These conclusions have been unanimously concurred in by the banks and their counsel. The interpretation of the law, however, is only one step in the matter. As

stated in the chapters of this report immediately following, it has been complemented by the classification of the associations in accordance with their financial condition, and by permitting the associations to enter into indemnity agreements with the banks under which they are given a reasonable opportunity to meet their obligations without impairing their usefulness. It is felt that, if the act is carefully followed in its entirety and the obligations of associations are liquidated as far as possible in accordance with the procedure outlined in the indemnity agreements, the financial condition of the associations will be materially strengthened. Associations in good condition with small or no matured obligations will be benefited in that they will not be obliged to bear, through the reduction of their dividends from the banks, any losses sustained by other associations until such associations have exhausted their resources available for the payment of their obligations.

This matter is of importance to the Federal land bank system because it is the very essence of real cooperation, which implies not only mutual interests and mutual privileges, but mutual responsibilities as well. One of the highest acts of cooperation performed by an association is the indorsement of the mortgages of its members, and one of its highest duties in carrying on that cooperation is the fulfillment of the obligation thus incurred in the event of default by the borrower. The mutuality of interest of all requires that the retiring borrower be not permitted to escape his share of responsibility for the obligations of the association incurred while he was a member and shift the entire burden to the remaining members, or, indirectly, to the other associations of the district. The discharge of duty by an association and its members in this connection is a part of real cooperation that is in the interest of borrowers, associations, and bank, alike. The strength and progress of the system—the greatest cooperative credit movement in the world—depend in large measure upon the fidelity with which its constituent parts make cooperation a real and living force in all its aspects. Devotion and loyalty to the best interests of the system demand no less.

Classification of National Farm Loan Associations.

The banks have worked out the practical application of the above-mentioned principles regarding the retirement of capital stock by first making a careful study of the financial condition of each association in their respective districts. When this study was completed the associations were classified by the respective banks on the basis of their condition, taking into consideration any indebtedness they may owe the bank and their ability to meet their obligations currently. Under the classification, when a borrower desires to pay off his loan in full to a Federal land bank and (*a*) the association through which the loan was made is in class 1, the association is entitled to receive the full proceeds of the stock subscribed for by it at the time the loan was made; (*b*) where the association is in class 2, the bank may pay to the association all or a portion of the proceeds of such stock, or withhold the entire proceeds; (*c*) where the association is in class 3 or 4, the bank retains the full amount of the proceeds of such retired stock and applies the same as a credit on the debts due by such association to the bank.

The secretary-treasurers of all associations in classes 2 and 3, where some or all of the proceeds of retired stock are being held by the bank, are required by the banks, when an application for a new loan is presented to the association to advise the applicant regarding its condition before the application is accepted. Associations in class 4 are not permitted to accept further applications for loans. These classifications, of course, are not permanent, as the associations will be reclassified periodically, or as their financial condition changes.

Indemnity Agreements.

The proper course to be followed with respect to the liability of national farm loan associations for loans made by Federal land banks has been a question that has been given exhaustive consideration by the board and the Federal land banks. As a result of the intensive study of this

problem, the Federal land banks are cooperating with the associations in their respective districts by entering into agreements with them for the purpose of minimizing losses and of obviating as far as possible the necessity for taking deficiency judgments against associations in connection with defaulted loans. Furthermore, much thought and study has been devoted to the form of these agreements. Recently the form has been standardized and with only minor changes has been adopted by each of the Federal land banks for use in their respective districts.

These agreements provide, in substance, that if there shall be a default under the terms of any mortgage indorsed by a national farm loan association, as a result of which it becomes necessary for the bank to acquire the mortgaged premises, an account shall be set up to which may be credited any moneys, otherwise payable to the association, as an indemnity against any loss that the bank may suffer in the final disposition of the property. Under such agreements the bank may proceed to dispose of the property for an amount which, in the opinion of the bank, is its fair value. If the sale price of the land so disposed of is less than the bank's investment, the deficiency is charged to the account. If the property sells for more than the bank's investment, the profits are credited to the association's account to the extent necessary to offset any losses on account of defaults in other loans made to its members. If in the final settlement there remains any surplus, it is paid to the association to such extent as may be necessary to reimburse it for losses which it may have sustained in connection with loans coming within the operation of the agreement. Under this procedure the association's interests, as well as the bank's, are protected and the acquired real estate is sold in an orderly manner. A specimen form of this agreement is attached to this report as Exhibit A.

The plan represents genuine cooperation between the banks and the associations in meeting their problems. It preserves the liability of the associations and avoids the necessity of the taking and execution of deficiency judgments against them in cases of foreclosures. At the same time it not only gives them a reasonable opportunity to meet

their obligations, but also gives them the advantage, in instances where the bank in the disposal of real estate receives more than its investment, of a credit to be applied on the association's indebtedness to the bank where a loss is sustained in the sale of other properties. It is distinctly a mutual undertaking in the interests of the banks and the associations alike.

The Federal land banks generally have felt that better results are accomplished by conducting foreclosures and handling the sale of the properties when acquired, through their own organizations, enlisting the cooperation of the associations in disposing of the properties and protecting the rights of both the banks and the associations through the indemnity agreements. In one district, however, most of the associations have followed the practice of initiating foreclosure proceedings in connection with defaulted loans where the delinquent installments have been paid by them to the bank. On the basis of the reports received by them from the associations, 11 banks reported that on December 31, 1929, 201 associations owned a total of 332 farms, involving unpaid principal on loans in the amount of $890,152.